

D.T.E. 98-31

Joint Petition of Bay State Gas Company, Northern Indiana Public Service Company and NIPSCO Acquisition Company for approval by the Department of Telecommunications and Energy pursuant to G.L. c. 164, § 96, of the merger of Bay State Gas Company and NIPSCO Industries, Inc.

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I. INTRODUCTION

On March 20, 1998, Bay State Gas Company ("Bay State"), Northern Indiana Public Service Company ("Northern Indiana"), and NIPSCO Acquisition Company<sup>(1)</sup> ("Acquisition Company") (collectively, the "Petitioners") jointly filed with the Department of Telecommunications and Energy ("Department") a petition for approval: (1) pursuant to G.L. c. 164, § 96, of the Merger of Acquisition Company and Bay State; (2) pursuant to G.L. c. 164, § 94, of Bay State's rate plan ("Rate Plan"); (3) pursuant to G.L. c. 164, § 14, of the issuance and sale of 100 shares of common stock, \$1.00 par value, by Acquisition Company to NIPSCO Industries, Inc. ("NIPSCO Industries"); (4) pursuant to G.L. c. 164, § 17A, of an amendment to Bay State's debt pooling agreement to include NIPSCO Capital Markets<sup>(2)</sup> ("NIPSCO Capital") as a party to the agreement; (5) pursuant to G.L. c. 164, § 8A(a), to operate Northern Indiana as a gas company in Massachusetts if the Alternative Merger, proposed by the Petitioners and described below, should occur. The Department docketed this matter as D.T.E. 98-31.

Pursuant to notice duly issued, the Department conducted public hearings in Lawrence, Springfield, and Brockton on May 14, 18, and 20, 1998, respectively, to afford interested persons an opportunity to comment on the Petitioners' proposal. The Department granted the petitions to intervene of the Commonwealth's Division of Energy Resources and the Utility Workers Union of America, Locals 273 and 273C ("Union").<sup>(3)</sup> The Attorney General of the Commonwealth ("Attorney General") intervened as of right pursuant to

G.L. c. 12, § 11E. The Department granted limited participant status to Eastern Enterprises, Enron Energy Services, Inc., and Essex County Gas Company.

The Department conducted evidentiary hearings at its offices in Boston on July 13, 14, and 15, 1998. The Petitioners sponsored the testimony of two witnesses: (1) James D. Simpson, senior vice president and head of regulated utility business of Bay State; and

(2) Mark T. Maassel, vice president of regulatory and government policy for NIPSCO Industries' Management Services Company and a corporate officer of NIPSCO Industries. The Attorney General sponsored the testimony of David J. Effron, a consultant in utility regulation. The Petitioners and the Attorney General submitted both briefs and reply briefs.

Bay State is a local distribution company ("LDC") serving approximately 261,000 residential, commercial and industrial customers in Massachusetts (Exh. Cos.-A at 6). Bay State's direct subsidiaries are Northern Utilities, Inc., an LDC that serves approximately 45,000 customers in New Hampshire and Maine, and Granite State Gas Transmission Company, Inc. ("Granite State"), an interstate pipeline company (Exh. Cos.-A at 6). Granite State's subsidiaries include Bay State's unregulated Energy Ventures and Energy Products & Services divisions, including EnergyUSA, Inc., Savage-Alert, Inc., and EnergyEXPRESS (Exhs. AG 1-1, Att. A; AG 1-2).

NIPSCO Industries is an exempt holding company<sup>(4)</sup> whose subsidiaries provide electricity, natural gas, and water service. These wholly-owned subsidiaries are Northern Indiana, Kokomo Gas and Fuel, Northern Indiana Fuel and Light Company, Crossroads Pipeline Company, NIPSCO Development, NI Energy Services, Inc., Primary Energy Inc., NIPSCO Capital, and IWC Resources Corporation ("IWC")<sup>(5)</sup> (Exh. Cos.-B at 3-4). Northern Indiana is a public service company, incorporated in the State of Indiana. Northern Indiana supplies gas and electric service over approximately 12,000 square miles in the northern portion of Indiana. Currently, Northern Indiana serves approximately 662,000 gas customers and 416,000 electric customers (Exh. Cos.-B at 3).

## II. DESCRIPTION OF PROPOSAL

### A. Introduction

The Petitioners have presented two merger options to the Department: (1) a Preferred Merger Structure that would reorganize Bay State as a wholly-owned subsidiary of NIPSCO Industries ("Preferred Merger"); and (2) an Alternative Merger Structure that would reorganize Bay State as the Massachusetts operating division of Northern Indiana ("Alternative Merger"). Both of these options are further described below. While the Petitioners are seeking approval of both options, they have expressed their intent to pursue the Preferred Merger if the Securities and Exchange Commission ("SEC") permits; and, accordingly, the Petitioners request that the Department inform the SEC that the Department favors the Preferred Merger (Exh. Cos.-B at 17).<sup>(6)</sup>

## B. Preferred Merger

Under the Preferred Merger, Northern Indiana would form Acquisition Company as a wholly-owned Massachusetts subsidiary corporation (Petition at 4; Exh. Cos.-A at 5). Upon Acquisition Company's formation, Acquisition Company would issue and sell 100 shares of common stock with a \$1.00 per share par value to NIPSCO Industries, in exchange for \$100 (Petition at 1). Shortly after Acquisition Company's formation, Bay State would merge with Acquisition Company. Acquisition Company would survive and would assume the name "Bay State Gas Company" (Exhs. Cos.-A at 5; Cos.-B, Sch. MTM-4, at A-1). Under the proposed merger, Bay State's shareholders would exchange each of their common shares issued and outstanding at the time of the merger for the right to receive: (1) \$40 in cash; or (2) NIPSCO Industries' common shares in an amount equivalent to \$40 per share;<sup>(7)</sup> or (3) a combination of cash and NIPSCO Industries' common shares, subject to an overall cash limitation of 50 percent of the total consideration paid by NIPSCO Industries (Exh. Cos.-B, Sch. MTM-4, at A-3). Acquisition Company would be the surviving company, in order to avoid income tax consequences for Bay State's shareholders (Exhs. DTE 1-13; AG 2-22). Shortly after the merger, Acquisition Company would change its name to Bay State Gas Company and transfer its interests in Northern Utilities and Granite State to NIPSCO Industries (Exh. Cos.-A at 6-7; Tr. 2, at 85). Thereafter, Bay State would operate as a stand-alone subsidiary of NIPSCO Industries, as would both Northern Utilities and Granite State (Exhs. Cos.-A at 5-7, 28; Cos.-B, Sch. MTM-3). The Petitioners state that the merger has been designed to qualify as a tax-free reorganization for federal income tax purposes, so that no tax gain or loss would be recognized (Exhs. Cos.-B at 19; AG 3-3, at 15). Under the Preferred Merger, Bay State, Northern Utilities and Granite State would continue to operate as separate corporations, each with its own books and records, capital structure, management structure, and board of directors (Exh. Cos.-A at 29-30).

## C. Alternative Merger

Under the Alternative Merger, NIPSCO would directly merge Bay State (and its subsidiaries) into NIPSCO Industries' primary LDC subsidiary, Northern Indiana (Exh. Cos.-A at 28-29). Thereafter, Northern Indiana would operate Bay State as its Massachusetts division and Northern Utilities as its New Hampshire and Maine divisions. Bay State would transfer its interest in Granite State to NIPSCO Industries. Granite State (along with its unregulated subsidiaries) would operate as a stand-alone subsidiary of NIPSCO Industries (Exhs. Cos.-A at 28-29; Cos.-B, Sch. MTM-3). The purchase price under the Alternative Merger would be identical to that under the Preferred Merger (Exh. Cos.-B, Sch. MTM-4, at A-3). Under the Alternative Merger, Northern Indiana's Massachusetts operations would have its own management structure and personnel distinct from the management structure and personnel of Northern Indiana's operations in Indiana, but would not have a separate board of directors (Exh. Cos.-A at 29-30).

## D. Accounting Treatment

The Petitioners intend to account for the transaction through "purchase accounting" whereby the acquiring company, NIPSCO Industries, would record the difference between the cost of the acquired enterprise and the sum of the values of tangible and identifiable assets, less liabilities, as a plant acquisition adjustment (Exhs. Cos.-A at 21; AG 2-13). According to the Petitioners, because purchase accounting is being used to record the acquisition, both the acquisition premium paid by NIPSCO Industries and the related transaction costs must be reflected on the books of the acquired company, Bay State (Exhs. Cos.-A at 21; AG 2-14; Tr. 2, at 125). The Petitioners stated that under generally accepted accounting principles ("GAAP"), Bay State would have no more than 40 years to write off the acquisition premium and transaction costs (Tr. 2, at 127).

#### E. Rate Plan

The Rate Plan consists of two components: (1) a base rate freeze; and (2) an earnings sharing mechanism ("ESM")<sup>(8)</sup> (Exh. Cos.-A at 17-18).

##### 1. Base Rate Freeze

The Petitioners propose to implement a five-year base rate freeze to commence upon the termination of Bay State's current rate plan, which is scheduled to end on October 31, 1999<sup>(9)</sup> (Exh. Cos.-A at 17; Tr. 1, at 14-15). The rate freeze would be subject to changes for exogenous factors that the Petitioners define as changes in tax laws, accounting principles, and regulatory, judicial, or legislative mandates (Exh. Cos.-A at 19). The Petitioners' proposal also reserves an opportunity for Bay State to seek a rate increase if, as a result of compliance with any new service quality measure(s), Bay State's annual revenue requirement increases by \$500,000 or more (Exh. Cos.-A at 19; Tr. 2, at 160-161). The proposal allows Bay State to terminate the Rate Plan should the rate of inflation be six percent or more in any twelve-month period (Exh. Cos.-A at 19-20).

##### 2. Earnings Sharing Mechanism

The Petitioners initially proposed to implement an ESM for Bay State with a 800 basis-point bandwidth ranging from 7.4 percent to 15.4 percent, centered on Bay State's currently authorized return on equity ("ROE") of 11.4 percent (Exh. Cos.-A at 17; Tr. 3, at 6-8). Under certain circumstances, earnings above or below the bandwidth would be shared between ratepayers and shareholders (Exh. Cos.-A at 17; Tr. 3, at 5). The Petitioners initially included the acquisition premium in Bay State's common equity balance for purposes of determining any ESM adjustment (Tr. 2, at 105-106; RR-DTE-1). During the hearings, however, the Petitioners decided to modify the ESM calculation so that neither the annual amortization of the acquisition premium nor the increased common equity balance would be included in the ESM if Bay State's ROE reached 7.4 percent (Petitioners Brief at 17; Tr. 2, at 135-136; Tr. 3, at 7-8). As part of the proposed ESM, Bay State would eliminate the weather normalization feature included in its current ESM (Cos.-A at 18).

#### F. Costs Associated with the Merger

The Petitioners project that the costs associated with the merger would be \$315 million (Exhs. AG 2-9; AG 2-9 (Supp.); Tr. 1, at 24). This projection includes \$310 million as an acquisition premium associated with the difference between the purchase price and the book value of Bay State's combined operations,<sup>(10)</sup> plus an estimated \$5 million in transaction costs for NIPSCO Industries, including legal, accounting, and financial expenses (Exhs. AG 2-9; AG 2-9 (Supp.); Tr. 1, at 23-26).<sup>(11)</sup> The Petitioners are not seeking recovery of the acquisition premium through rates at this time (Exh. Cos.-A at 21). However, they request that the Department include in its order a finding that Bay State may seek recovery of the annual amortization of the acquisition premium in future rate proceedings to the extent offset by merger-related savings (Exh. Cos.-A at 21).

### III. STANDARD OF REVIEW

The Department's authority to review and approve mergers and acquisitions is found at G.L. c. 164, § 96, which, as a condition for approval, requires the Department to find that mergers and acquisitions are "consistent with the public interest". In Boston Edison Company, D.P.U. 850, at 6-8 (1983), the Department construed § 96's standard of consistency with the public interest as requiring a balancing of the costs and benefits attendant on any proposed merger or acquisition. The Department stated that the core of the consistency standard was "avoidance of harm to the public." D.P.U. 850, at 5. Therefore, under the terms of D.P.U. 850, a proposed merger or acquisition is allowed to go forward upon a finding by the Department that the public interest would be at least as well served by approval of a proposal as by its denial. D.P.U. 850, at 5-8; Eastern-Essex Acquisition at 8 (1998).<sup>(12)</sup> The Department has reaffirmed that it would consider the potential gains and losses of a proposed merger to determine whether the proposed transaction satisfies the § 96 standard. Eastern-Essex Acquisition at 8; Boston Edison Company, D.P.U./D.T.E. 97-63, at 7 (1998); Mergers and Acquisitions at 6, 7, 9 (1994). The public interest standard, as elucidated in D.P.U. 850, must be understood as a "no net harm," rather than a "net benefit" test.<sup>(13)</sup> Eastern-Essex Acquisition at 8. The Department considers the special factors of an individual proposal to determine whether it is consistent with the public interest. Eastern-Essex Acquisition at 8; D.P.U./D.T.E. 97-63, at 7; Mergers and Acquisitions at 7-9. To meet this standard, costs or disadvantages of a proposed merger must be accompanied by offsetting benefits that warrant their allowance. Eastern-Essex Acquisition at 8; D.P.U./D.T.E. 97-63, at 7; Mergers and Acquisitions at 18-19.

Various factors may be considered in determining whether a proposed merger or acquisition is consistent with the public interest pursuant to G.L. c. 164, § 96. These factors were set forth in Mergers and Acquisitions: (1) effect on rates; (2) effect on the quality of service; (3) resulting net savings; (4) effect on competition; (5) financial integrity of the post-merger entity; (6) fairness of the distribution of resulting benefits between shareholders and ratepayers; (7) societal costs, such as job loss; (8) effect on economic development; and (9) alternatives to the merger or acquisition. Eastern-Essex Acquisition at 8-9; D.P.U./D.T.E. 97-63, at 7-8; Mergers and Acquisitions at 7-9. This list is illustrative and not exhaustive, and the Department may consider other factors

when evaluating a § 96 proposal. Eastern-Essex Acquisition at 9; Mergers and Acquisitions at 9.

With respect to the recovery of acquisition premiums, the Department has found that if a petitioner can demonstrate that denial of recovery of an acquisition premium would prevent the consummation of a particular merger that otherwise would satisfy G.L. c. 164, § 96, then the Department may be willing to consider recovery of an acquisition premium.<sup>(14)</sup> Eastern-Essex Acquisition at 9; Mergers and Acquisitions at 18-19. The Department will determine whether an acquisition premium should be allowed in a specific case by applying the general balancing of costs and benefits under the § 96 consistency standard. Eastern-Essex Acquisition at 9; Mergers and Acquisitions at 18-19. Thus, allowance or disallowance of an acquisition premium would be but one part of the cost/benefit analysis under the § 96 consistency inquiry. Eastern-Essex Acquisition at 9; Mergers and Acquisitions at 7.

The Department's determination whether the merger or acquisition meets the requirements of § 96 must rest on a record that quantifies costs and benefits to the extent that such quantification can be made. Eastern-Essex Acquisition at 10; Mergers and Acquisitions at 7. A § 96 petitioner who expects to avoid an adverse result cannot rest its case on generalities, but must instead demonstrate benefits that justify the costs, including the cost of any premium sought. Eastern-Essex at 10; Mergers and Acquisitions at 7. This admonition is particularly apt where allowance of an acquisition premium is sought. Eastern-Essex at 10; Mergers and Acquisitions at 7.

#### IV. SPECIFIC CONSIDERATIONS OF THE MERGER

In considering the Petitioners' proposal, the Department's analysis focuses on the following: (1) effect on rates and resulting net savings; (2) effect on the quality of service; (3) societal costs; (4) acquisition premium; and (5) financial integrity of the post-merger gas company.

##### A. Effect on Rates and Resulting Net Savings

###### 1. Base Rate Freeze

###### a. Introduction

The Petitioners propose to implement a five-year base rate freeze, commencing on November 1, 1999<sup>(15)</sup> (Exh. Cos.-A at 17; Tr. 1, at 14-15). The proposed rate freeze would not apply to the Cost of Gas Adjustment Clause ("CGAC") or to the Distribution Adjustment Cost Clause ("DACC")<sup>(16)</sup> (Exh. Cos.-A at 17). Bay State would retain flexibility to propose revenue-neutral rate design changes (Exh. Cos.-A at 17).

As proposed by the Petitioners, the Bay State Rate Plan would be subject both to upward rate adjustment during its term and to cancellation if certain conditions arise. The Petitioners propose that the rate freeze be subject to changes resulting from two

conditions: (1) if changes in all exogenous factors taken together increase Bay State's annual revenue requirement by \$500,000 or more;<sup>(17)</sup> and/or (2) if Bay State projects that compliance with new service quality parameters implemented during the term of the rate plan would increase its annual revenue requirement by \$500,000 or more (Exh. Cos.-A at 19-20; Tr. 2, at 160-161).<sup>(18)</sup> Additionally, Bay State proposes to terminate the rate freeze if the rate of inflation as measured by the Gross Domestic Product-Price Index ("GDP-PI") equals or exceeds six percent for any twelve-month period (Exh. Cos.-A at 19-20).

## b. Positions of the Parties

### i. Attorney General

The Attorney General states that the Department has not always found that a rate freeze would benefit ratepayers (Attorney General Brief at 8). The Attorney General maintains that no evidence has been introduced to demonstrate that the proposed rates, as of November 1, 1999, would be just and reasonable as compared to either the present rates or rates set pursuant to traditional ratemaking (Attorney General Brief at 14).

In particular, the Attorney General asserts that the benefits of Bay State's corporate restructuring and the cumulative base rate increases of \$3.6 million approved by the Department in Bay State Gas Company, D.T.E. 97-97 (1997), could contribute to a revenue excess when the present rate plan expires (Attorney General Brief at 14). If the revenue excess occurs, the Attorney General argues that the combination of the Petitioners' proposed ESM and the amortization of the acquisition premium would likely preclude Bay State's ratepayers from sharing any excess revenues (Attorney General Brief at 14, citing Exh. AG-1, at 8). Thus, the Attorney General concludes, that when analyzed in the context of a potential overearnings situation, the proposed ESM and the amortization of the acquisition premium would make the five-year rate freeze disadvantageous to ratepayers (Attorney General Brief at 14).

The Attorney General proposes an alternative rate plan (Exh. AG-1, at 24). The Attorney General recommends that, upon the expiration of the existing rate plan, the Department order the Petitioners to implement a three-year base rate freeze (Exh. AG-1 at 24). The Attorney General states that his proposed rate freeze would be subject to exogenous factors similar to those outlined by Bay State (Exh. AG-1 at 26). However, the Attorney General suggests that any one individual exogenous cost increase or decrease should meet a threshold of \$1,500,000 per year instead of the \$500,000 per year threshold recommended by the Petitioners (Exh. AG-1, at 26).

### ii. Petitioners

The Petitioners contend that customers benefit from a five-year base rate freeze since they would be protected from any base rate increase during that time (Exh. Cos.-A at 25; Tr. 3, at 23). Moreover, the Petitioners claim that, absent the merger, Bay State would not freeze rates after its current rate plan expires (Exh. Cos.-A at 25). The Petitioners note that during the proposed five-year rate freeze, they would bear the risk of an increase in

the rate of inflation (up to six percent over a 12-month period) and any reduction in sales (Petitioners Brief at 29).

With respect to the Attorney General's position that extending the current rate plan for an additional three years would produce greater benefits for Bay State's ratepayers than the proposed Rate Plan, the Petitioners state that the current plan is the product of a settlement agreement and cannot be extended unilaterally (Petitioners Brief at 30-31). Additionally, the Petitioners contend that continuing the current rate plan would not be advantageous to customers because, pursuant to the settlement, incremental revenues, which Bay State would be allowed to recover over an additional five years, total as much as \$31 million (Petitioners Brief at 31).<sup>(19)</sup>

Furthermore, the Petitioners maintain that the Attorney General's assertion that Bay State may have a revenue excess after October 31, 1999 is speculative (Petitioners Brief at 30). The Petitioners reject the Attorney General's argument that termination of the current amortization of corporate restructuring costs and the realization of benefits from this restructuring may produce excess revenues at the end of the two-year settlement. In response to the Attorney General's argument concerning excess revenues, the Petitioners note that corporate restructuring costs would be offset by ongoing price increases from inflation and the implementation of other constraints imposed on productivity by G.L. c. 164, § 1E (Petitioners Brief at 30).<sup>(20)</sup> Finally, the Petitioners argue that, unlike traditional incentive regulation plans, Bay State's proposed Rate Plan would not increase rates to account for inflation and therefore it is "a true rate freeze for Bay State's customers" (Petitioners Reply Brief at 7). The Petitioners did not address the Attorney General's alternative rate freeze proposal on brief.

### c. Analysis and Findings

Subject to points noted in this analysis, the Department finds that ratepayers would not be harmed by the proposed five-year rate freeze. The record indicates an historic pattern, since 1982, of Bay State receiving rate increases every two to five years.<sup>(21)</sup> Therefore, the rate freeze most likely would allow ratepayers to avoid some level of rate increases over the five-year period. Also, because the rate freeze does not include an adjustment for inflation, it actually represents a "real" rate decrease for customers over the five-year period.<sup>(22)</sup>

Because the Petitioners' proposed rate freeze meets the § 96 standard, we do not need to turn to the Attorney General's alternative proposal for a three-year rate freeze. However, we note that the benefits of a non-inflation adjusted rate freeze are compounded the longer the term of the rate freeze. In terms of the Attorney General's claim that there may be excess earnings at the expiration of the current rate plan resulting from the elimination of the amortization of corporate restructuring costs, we note that just as strong a case can be made for cost increases (such as inflationary pressures and costs related to distribution system growth) that would balance out or even exceed the potential savings. The only way to determine whether potential cost savings outweigh cost increases would be to actually measure those cost savings in a rate case at the expiration of the current rate

plan. On balance, given Bay State's historic experience of rate increases every two to five years, we believe that ratepayers are better served by a commitment now to a five-year rate freeze than by a rate-case examination of actual cost savings and cost increases at the expiration of the current rate plan.

With respect to exogenous factors, the Department has defined these factors as positive or negative cost changes beyond a company's control that would significantly affect that company's operations. Eastern-Essex Acquisition at 19, citing D.P.U. 96-50 (Phase I) at 292. The exogenous factors proposed by the Petitioners are identical to those set forth and accepted by the Department in Eastern-Essex Acquisition and Boston Gas Company, D.P.U. 96-50 (Phase I) at 292. There is no compelling evidence or policy reason to expand the list of factors. Therefore, the Department accepts the Petitioners' exogenous factors.

The Petitioners' request to establish exogenous cost adjustments that would go into effect without regulatory review is not acceptable. Whether or not a cost change is actually an exogenous event is often subject to interpretation and disagreement. Bell Atlantic-Massachusetts' Fourth Annual Price Cap Compliance Filing, D.T.E. 98-67. Leaving that determination to a regulated utility would be an inappropriate delegation of regulatory authority; and, more important, it would be inconsistent with the requirements of G.L. c. 164, § 94, which requires that a general rate increase be noticed and subject to a Department hearing. During the Rate Plan, if the Petitioners seek to recover any exogenous costs, they must propose exogenous cost adjustments, with supporting documentation and rationale, to the Department for determination as to the appropriateness of recovery of the proposed exogenous costs.

Concerning the \$500,000 cumulative threshold for exogenous cost changes, the Department has stated that there should be a threshold for qualification as an exogenous cost in order to avoid regulatory battles over minimal dollars. Boston Gas Company, D.P.U. 96-50 at 288. The Department's intent in establishing this requirement was to ensure that any individual exogenous cost must exceed a threshold in order to qualify for recovery. Id. Thus, the Department finds that the impact for any individual exogenous cost must exceed \$500,000 in a particular year in order for the Petitioners to request recovery. Moreover, the Department will not pre-determine whether an increase in the inflation rate of six percent or more in any twelve month period warrants terminating the rate freeze. Extraordinary economic circumstances have always been a recognized basis for any gas or electric company to petition the Department for changes to tariffed rates. Similarly, the Department may make such changes if extraordinary economic circumstances, such as significant cost deflation, provide the company with a windfall. <sup>(23)</sup> Therefore, the Department sees no need to approve the Petitioners' proposal allowing it to terminate the rate freeze in the event of a 6 percent inflation rate increase over a 12-month period. For a rate freeze to be a meaningful benefit to ratepayers and thereby to offset identified costs of a merger or acquisition, the rate freeze cannot be so heavily encumbered with qualifications and potential "outs." Again, if serious adverse circumstances were presented during a valid rate freeze, the Department would not be indifferent to reasonable adjustments, properly supported.

## 2. Earnings Sharing Mechanism

### a. Introduction

The Petitioners propose to implement an ESM for Bay State that is similar to the one approved by the Department in D.P.U. 96-50 (Phase I) at 325-326. Under the proposed ESM, an 800 basis-point-bandwidth would be centered on Bay State's most recently authorized ROE of 11.4 percent,<sup>(24)</sup> thus creating a bandwidth ranging from 7.4 percent to 15.4 percent (Exh. Cos.-A at 17; Tr. 3, at 6-8). If Bay State's fiscal year (October 1 through September 30) earnings result in an earned ROE above 15.4 percent, then 25 percent of the difference between the earned ROE and the maximum 15.4 percent established under the bandwidth would be passed back to ratepayers (Exh. Cos.-A at 17; Tr. 3, at 5). Conversely, if Bay State's earned ROE for the fiscal year falls below the minimum 7.4 percent level, ratepayers would be charged 25 percent of the difference between the earned ROE and the minimum 7.4 percent (Exh. Cos.-A at 17). Bay State would submit annual filings with the Department to report on the updated earnings sharing calculation (Exh. Cos.-A at 20).

In their initial filing, the Petitioners proposed to include the amortization of the acquisition premium in both the numerator and the denominator of the ROE for the earnings sharing calculation (Exh. Cos.-A at 17). However, during hearings, the Petitioners stated that "if all other elements of the merger rate plan proposal and the Joint Application were approved by the Department, it would be reasonable to exclude the pushed down equity<sup>(25)</sup>

from the proposed calculation of the ESM so that *only* the annual amortization of the acquisition premium expense would be reflected in the calculation" (Petitioners Brief at 18; Tr. 3, at 12). Further, the Petitioners state that they would exclude both the annual amortization and the increased equity balance from the acquisition premium in the earnings sharing calculation if their inclusion would cause the calculation of Bay State's ROE to fall below 7.4 percent (Petitioners Brief at 17).

### b. Positions of the Parties

#### i. Attorney General

The Attorney General maintains that the proposed ESM, when considered in conjunction with the proposed recovery of the acquisition premium, is not consistent with the public interest and is less beneficial to customers than the ESM in Bay State's current rate plan (Exh. AG-1, at 8, 11). The Attorney General argues that charging the amortized value of the acquisition premium against earnings when calculating the ESM would make the possibility of earning an ROE greater than 15.4 percent unlikely (Exh. AG-1, at 24). In addition, the Attorney General asserts that the Petitioners provided no record evidence supporting their proposal to adopt the ESM parameters approved by the Department in D.P.U. 96-50 (Phase I) (Attorney General Brief at 15).

The Attorney General recommends that the Department approve an ESM with a benchmark ROE of 11.0 percent instead of the currently authorized 11.4 percent (Exh. AG-1, at 27). The Attorney General asserts that 11.0 percent is warranted since the Petitioners propose to eliminate weather normalization as a component of the ESM calculation

(Exh. AG-1, at 28). The Attorney General maintains that if, as the Petitioners state, eliminating the weather normalization component in the ESM calculation reduces investors' exposure to weather risk and improves Bay State's ability to manage their business, then eliminating this component would be advantageous to Bay State (Exhs. AG-1, at 18; Cos.-A at 18). Therefore, the Attorney General asserts that eliminating the weather normalization component should be taken into account in the design of the ESM (Exh. AG-1, at 18). Moreover, the Attorney General states that the 11.0 percent ROE is acceptable since customers are not offered a reduction in base rates from any cost savings attributable to the merger (Exh. AG-1, at 28).

Further, the Attorney General requests that the Department order a 75/25 split between ratepayers and shareholders for any earnings between an 11.0 and 15.0 percent ROE (Exh. AG-1, at 27). The Attorney General also proposes that 100 percent of earnings over the 15.0 percent ROE be returned to ratepayers (Exh. AG-1, at 27).

## ii. Petitioners

The Petitioners maintain that their proposed ESM, modeled on the mechanism established by the Department in Boston Gas, D.P.U. 96-50, mitigates the significant risk and uncertainty for shareholders of a five-year rate freeze (Petitioners Brief at 15). Moreover, the Petitioners argue that including the amortization of the acquisition premium in the earnings calculation during the rate freeze reasonably allocates the benefits of a rate freeze to ratepayers. Further, the opportunity for earnings sharing is balanced against the risks assumed by the Petitioners during the rate freeze (Petitioner Brief at 16).

Regarding the Attorney General's request to continue the current ESM with modifications, the Petitioners assert that it is inappropriate to modify one component of the settlement and not consider other components of the settlement (Exh. Cos.-C at 2). Specifically, the Petitioners contend that the weather normalization in the current ESM was acceptable to the settling parties because of other offsetting considerations, such as the amortization of \$3.7 million in corporate restructuring costs in the current ESM, the recovery of third party unbundling costs and the recovery of statutorily-mandated costs (Petitioners Brief at 32). The Petitioners assert that the settlement approved in D.P.U. 97-97 has no precedential value, and therefore, cannot be relied upon in subsequent proceedings (Exh. Cos.-C at 2).

With respect to the Attorney General's proposed 11.0 percent benchmark ROE, the Petitioners argue that the Attorney General failed to provide a cost of capital analysis or testimony on rate of return to support his recommendation (Petitioners Brief at 32). Furthermore, the Petitioners contend that allocating 75 percent of all earnings to ratepayers that exceed this reduced ROE of 11.0 percent would deny the Petitioners any recognition of the costs reflected in the acquisition premium (Petitioners Brief at 32). The Petitioners claim that "if [NIPSCO] Industries is not given the opportunity to recover its investments, the merger will not be completed" (Petitioners Reply Brief at 4).

## c. Analysis and Findings

The Department has reviewed the Petitioners' proposed ESM and declines to approve its implementation for the reasons set forth below.

Allowing the Petitioners to increase rates automatically, should the ROE fall below 7.4 percent, presents a risk of a rate increase before the end of the proposed rate freeze. This risk to ratepayers would diminish the value of the rate freeze. Moreover, because the Petitioners propose to subtract the annual amortization of the acquisition premium from earnings in calculating the earned ROE, it is unlikely that the ROE would exceed 15.4 percent. That ratepayers would share any excess earnings under the Rate Plan's ESM seems

quite improbable. Yet, the Petitioners' proposal does present the risk of a rate increase before 2004. In addition, the Petitioners are already protected from significant changes in exogenous costs during the term of the Rate Plan. Adding the ESM "belt" to the exogenous factors "suspenders" would serve to protect the Petitioners from the consequences of their own endogenous actions. Therefore, the Department finds that the Petitioners' proposed ESM is not consistent with the public interest. For the same reasons, the Department also rejects the Attorney General's proposed ESM.

Comparison of the Petitioners' proposed Rate Plan to Boston Gas's PBR plan is misplaced. A PBR plan is a substitute for traditional cost-of-service regulation that takes into account inflation factors and analyzes an industry's productivity compared with the economy-wide productivity. Consideration of a PBR may, but need not, include an examination of the appropriateness of an earnings sharing mechanism. Eastern-Essex Acquisition citing D.P.U. 96-50 (Phase I) at 259-339 and NYNEX, D.P.U. 94-50, at 91-273. The Petitioners' proposed Rate Plan is not a PBR. It does not include either an inflation factor or an analysis of industry productivity. It represents no change in traditional cost of service regulation. Even if the Rate Plan were a PBR, inclusion of an ESM is not a necessary feature of a PBR; rather, it is a component that may be evaluated in the specific circumstances of each company's filing.

### 3. Gas Costs

#### a. Introduction

The Petitioners state that the merger will allow the combined companies, over time, to take advantage of economies and efficiencies relating to coordinated gas supply, optimized use of gas transportation capacity, geographic differences between Northern Indiana's and Bay State's core markets, more efficient use of NIPSCO Industries' gas storage facilities, and enhanced ability to benefit from new gas projects (Exh. Cos.-B at 14). The Petitioners further state that as a result, Bay State's customers would save approximately \$1.8 million per year in gas costs (Exh. AG 2-16 (Supp.) at 1).[\(26\)](#)

#### b. Positions of the Parties

##### i. Attorney General

The Attorney General argues that the Petitioners have failed to support their projected \$1.8 million in gas cost savings (Attorney General Reply Brief at 8-9). The Attorney General contends that the estimate of gas cost savings should be accorded little weight given the level of uncertainty and speculative nature of the Petitioners' analysis (Exhs. AG 2-16; AG 2-16 (Supp.) at 1; Tr. 3, at 70-71; Attorney General Reply Brief at 8). The Attorney General contends that the Petitioners admitted that the gas cost savings forecast is based on joint purchasing and highly speculative "price risk management" through the use of futures contracts (Attorney General Reply Brief at 9, citing Tr. 2, at 148). The Attorney General further asserts that the Petitioners admitted that the estimated gas cost savings provide few benefits for approximately 25,000 Bay State transportation customers under Bay State's Customer-Choice Program (Tr. 1, at 72).[\(27\)](#) Finally, the Attorney General notes that, as acknowledged by the Petitioners, no gas cost savings would be realized by Bay State customers "if the Department adopts the portfolio out-sourcing proposal" being considered in NOI-Gas Unbundling, D.T.E. 98-32 (Attorney General Reply Brief at 9).

##### ii. Petitioners

The Petitioners contend that, as a result of the merger, they will be able to take advantage of market opportunities and market conditions through joint management of their combined portfolios (Exh. AG 2-16 (Supp.) at 1; Petitioners Brief at 20). The Petitioners assert that joint management of the portfolios,[\(28\)](#) the associated sharing of market information, and the diversity of physical and contracted assets[\(29\)](#) would create opportunities for additional benefits through the use of price risk management tools, real-time trading, and asset optimization (Exh. AG 2-16 (Supp.) at 1; Petitioners Brief at 20). The Petitioners recognize that a portion of the \$1.8

million projected gas cost savings would result from certain hedging transactions that are currently not recognized or approved by the Department (Petitioners Brief at 20).

c. Analysis and Findings

The Department has reaffirmed the importance of cost savings by utility companies and its expectation that all utilities explore any and all measures that provide the opportunity for these savings. Eastern-Essex Acquisition at 26, citing Mergers and Acquisitions at 18. In addition, the Department has stated that mergers and acquisitions are a useful and potentially beneficial mechanism for utility companies to consider in meeting their service obligations. Eastern-Essex Acquisition at 26. The Department here evaluates (1) whether the opportunity exists for the Petitioners to achieve the savings described in the proposal while maintaining the level of service and reliability Bay State Gas customers have experienced; and (2) whether the projections of the Petitioners are reasonable based on the evidence.

The Department recognizes that the \$1.8 million per year in gas cost savings are estimated and that the magnitude of this value would vary from year to year. That the savings are estimated is not itself grounds for rejection of the Rate Plan. All calculations of the impact of future events are based on an estimation of likelihood. The point is to judge whether, based on logic, fact, and law, such estimations may reasonably be relied upon in assessing costs and savings. Eastern-Essex Acquisition at 26.

The evidence indicates that the Petitioners' estimate relies too heavily on insufficiently supported assumptions about joint management of the two companies' portfolios, shared intelligence about the market on a daily basis, and the diversity of physical and contracted assets to permit quantification of the gas costs savings (Petitioners Brief at 20). Cf. Eastern-Essex Acquisition at 26. Nevertheless, the Department agrees with the Petitioners that the proposed merger promises significant (albeit of indeterminate size) savings for ratepayers because Bay State and Northern Indiana would engage in joint management and purchasing of gas supplies, resulting in greater economies and efficiencies. Thus, with respect to gas costs, ratepayers are likely to be better off, and certainly no worse off, than they would be absent the merger.

Although the Department has not permitted the use of risk management tools to reduce costs to ratepayers, we acknowledge that with the evolution of the gas marketplace, the use of various price risk management tools also has the potential to yield gas costs savings with less risk to ratepayers than in the past. Moreover, Bay State's affiliation would be with a much larger company; and the prudent use of these risk management tools by large entities would tend to reduce the risk to ratepayers of companies like Bay State.

4. Weather Normalization

a. Introduction

The Petitioners propose to eliminate the weather normalization(30) component of the existing ESM (Exh. Cos-A at 18).

b. Positions of the Parties

i. Attorney General

The Attorney General argues that it would be inappropriate to modify unilaterally the weather normalization component of the current ESM since that resulted from the unanimous consent of all parties to a settlement (Exh. AG-1, at 17). The Attorney General agrees

with the Petitioners' assertion that if the Department eliminates weather normalization in the proposed ESM, then the risk to shareholders would be reduced (id. at 18). However, the Attorney General asserts that if an ESM is implemented after November 1, 1999, without weather normalization, the elimination of that component should be taken into account in designing the proposed ESM (id.).

## ii. Petitioners

The Petitioners assert that the elimination of the weather normalization component of the existing ESM is consistent with D.P.U. 96-50 and, thus, is reasonable (Petitioners Brief at 15). The Petitioners state that inclusion of a weather normalization component in an ESM unreasonably magnifies the risk of earnings stability to shareholders and of foregone revenue credits to ratepayers, and interferes with Bay State's ability to manage its business (Exhs. Cos.-A at 18; Cos.-C at 4; Tr. 2, at 109). The Petitioners disagree with the Attorney General's position that only Bay State's shareholders would benefit by eliminating weather normalization and assert that ratepayers would benefit during a year with colder than normal temperatures, because adjusting earnings for weather in the earnings sharing calculation would decrease net income (Exh. Cos.-C at 4; Tr. 2, at 108-109).[\(31\)](#)

Finally, in response to the Attorney General's proposal for an 11 percent ROE, the Petitioners argue that if weather normalization is eliminated from the ESM, then Bay State's sales and earnings would be affected by weather and, therefore, the Department should not reduce Bay State's ROE (Exh. Cos.-C at 4).

## c. Analysis and Findings

The weather normalization component in the existing ESM is the result of a settlement and it would be inappropriate to modify the settlement unilaterally. Therefore, the Department rejects the Petitioners' proposal to eliminate the weather normalization component of the existing ESM. Given that the Department has rejected the Petitioners' proposal for an ESM to apply after the end of the existing settlement, we need not address the issue of weather normalization here and decline to do so.

## B. Effect on Quality of Service

### 1. Introduction

Bay State has implemented a service quality index ("SQI") pursuant to the settlement agreement that was approved by the Department in D.P.U. 97-97.[\(32\)](#) These service quality measures will remain in effect until expiration of Bay State's current rate plan on October 31, 1999 (Exh. Cos.-A at 18). The Petitioners propose to modify the current measures before the effective date of the proposed five-year rate plan (id.). The Petitioners request the opportunity to seek a rate increase if they project that compliance with the new service quality measures would cause Bay State to incur an annual revenue requirement increase of \$500,000 or more (id. at 19).

### 2. Positions of the Parties

#### a. Attorney General

The Attorney General argues that before allowing a rate increase for compliance with any new service quality measures, the Department should require Bay State to establish that it experienced a revenue deficiency as a result of increased costs that it incurred to comply with the modified service quality measures (Attorney General Brief at 16). Similarly, the Attorney General contends that if costs decrease as a result of the implementation of new service quality measures and Bay State earns in excess of its rate of return, then Bay State should be required to reduce its rates (Attorney General Brief at 16).

b. Petitioners

The Petitioners agree with the Attorney General that if modifications to Bay State's service quality indices result in a reduction of costs of more than \$500,000, this reduction should be passed back to customers. This reduction would flow through the DACC (Petitioners Brief at 17; Petitioners Reply Brief at 5-6).

3. Analysis and Findings

The Department retains oversight of a company's service quality pursuant to

G.L. c. 164, § 76, and has stated that an SQI is an important bulwark against deterioration in a company's service to its customers. Eastern-Essex Acquisition at 32-33;

D.P.U./D.T.E. 97-63, at 15 (1998); Mergers and Acquisitions at 8-10. The Petitioners have not presented a proposal for a service quality plan extending beyond the date that the current settlement agreement ends, November 1, 1999. [\(33\)](#)

To ensure that there will be no reduction in the quality of service following consummation of the merger, the Department directs Bay State to continue to use the current quality of service measures and penalties as approved by the Department in D.T.E. 97-97, until November 1, 2004, the date the Rate Plan ends. When Bay State proposes to change the current SQI, the Department would review any proposed amendments. The Department will consider whether any additional cost adjustments related to the SQI are, on their own merits, warranted. The Department does not approve the Petitioners proposed \$500,000 threshold.

C. Acquisition Premium

1. Introduction

As noted in Section II.F, above, the Petitioners estimate that the merger would result in an acquisition premium of approximately \$310,000,000, based on the purchase price of \$40 per-share book-value of Bay State's assets and on the number of Bay State shares anticipated to be outstanding as of the consummation of the merger [\(34\)](#) (Exhs. Cos.-B at 19; AG 2-9; Tr. 3, at 27-28). The Petitioners propose to allocate the acquisition premium, consistent with GAAP requirements, proportionately among Bay State and its subsidiaries [\(35\)](#) at the time of the consummation of the merger (Exh. DTE 1-20). The actual calculation would be based on a review of Bay State's accounts, the final costs of the transaction, and the extent to which Bay State's shareholders exercise the cash option feature of the merger (Tr. 1, at 23-26; Tr. 2, at 123, 133-134). The Petitioners estimate that Bay State's stand alone share of the total acquisition premium will be \$216 million (Tr. 2, at 133). The Petitioners propose to amortize the acquisition premium over a period not exceeding forty years, consistent with GAAP requirements (Exh. Cos.-A at 21). The actual period would be determined in a post-merger review of the allocation of the total acquisition premium among Bay State and its subsidiaries (Exh. Cos.-A at 21; Tr. 2, at 127).

The Petitioners request that the Department expressly recognize that Bay State may seek the opportunity in future rate proceedings to recover the annual amortization of the acquisition premium expense, after the five-year rate freeze ends, but only to the extent that the premium may be offset by demonstrable merger-related savings (Exhs. Cos.-A at 21; Cos.-B at 21). During the term of the rate freeze itself, the Petitioners propose to apply any savings realized through the merger as an offset to the amortization of the acquisition premium (Tr. 2, at 38-39).

The Petitioners state that although the proposal lacks currently quantifiable benefits, there would be certain savings of undetermined magnitude for Bay State (Tr. 1, at 35-37). The Petitioners estimate savings of \$1.5 million per year as a result of Bay State's improved

access to capital (Exhs. Cos.-A at 16; Cos.-B at 9, 15; AG 2-16 (Supp.) at 3; Tr. 2, at 145-146). Further, the Petitioners estimate that certain corporate costs, such as directors' fees and expenses, will likely be reduced by about \$200,000 per year (Exh. AG 2-16 (Supp.) at 2;

Tr. 2, at 145-146). In addition, the Petitioners project savings from stock transfer and trustee fees of \$200,000 per year (Exh. AG 2-16 (Supp.) at 2). Finally, according to the Petitioners, the current level of costs of investor services are expected to decrease for Bay State by \$345,000 annually (Exh. AG 2-16 (Supp.) at 2; Tr. 2, at 145-146).

## 2. Positions of the Parties

### a. Attorney General

The Attorney General contends that, as Bay State argued in Mergers and Acquisitions, a company should not be allowed to use an accounting method that would result in lower net savings for customers and would produce higher costs (Attorney General Brief at 16-17). The Attorney General notes that although the Petitioners intend to use purchase accounting, pooling of interests accounting would result in a higher net savings to ratepayers (id.).

The Attorney General argues that the regulatory recoverability of an acquisition premium should not be dependent on the method of accounting used to record the merger (id. at 19). While the Attorney General acknowledges that the Petitioners are required to use purchase accounting to record the merger transaction on their books pursuant to GAAP, he argues that the Department should require the Petitioners to use pooling of interests accounting to determine any allowable acquisition premium (id.). The Attorney General reasons that the dilution to book value, as determined under pooling of interests accounting, is the appropriate measure of any acquisition premium resulting from this merger (id. at 19-20). Noting that the transaction would be effected primarily through an exchange of NIPSCO Industries' common stock for Bay State's common stock, the Attorney General maintains that the premium to book value of NIPSCO Industries' stock more than offsets the premium to book value being offered for Bay State's stock (id. at 21). According to the Attorney General, this differential results in a higher book value per share for NIPSCO Industries after the consummation of the merger than before the merger (id.). The Attorney General concludes that the Petitioners would not experience any earnings dilution under pooling of interests accounting (id.).

The Attorney General argues that the Petitioners plan to "charge off" to their customers a \$210 million acquisition premium and to incorporate those effects that the acquisition premium would have on Bay State's capital structure (Attorney General Reply Brief at 4). The Attorney General contends that the cost of service will increase by approximately \$44 million, consisting of \$5 million in the annual amortization of the acquisition premium, plus another \$39 million for the change in the cost of capital (id. at 4-5). Accordingly, the Attorney General asserts that based on these numbers, the Petitioners will have to achieve \$44 million in gross annual savings, or a 30 percent reduction in the cost to serve, before ratepayers will see any of the benefits of the merger (id. at 5). The Attorney General concedes that the Petitioners' modification to their proposed ESM made during these proceedings eliminates the harm to ratepayers resulting from the inclusion of the acquisition premium in Bay State's capital structure during the term of the rate freeze. Even so, the Attorney General argues that this increase will directly harm ratepayers after the freeze, because of the effect on the cost of service (through the amortization of the acquisition premium and the change in Bay State's capital structure) (id.).

The Attorney General contends that the Petitioners designed the merger so that Bay State's ratepayers would pay the costs of the merger to NIPSCO Industries while Bay State's shareholders retain benefits (id.). Analogizing the acquisition premium as a gain on the sale of utility assets, the Attorney General contends that if the Department is going to recognize the acquisition premium as a cost

that can be recovered from ratepayers, then it is only fair that the premium being paid to Bay State stockholders be flowed back to customers (*id.*). The Attorney General asserts that such an approach would be consistent with Department policy where "the Department has recognized that the gain on the sale of assets that have been supported by the ratepayers are to be flowed through to the ratepayers" (*id.* at 5-6).

The Attorney General argues that the Petitioners did not establish that there would be benefits to customers since there is no quantification of benefits and no comparison of potential benefits to the costs of the merger (Attorney General Brief at 9). Specifically, the Attorney General contends that any quantification of benefits made by the Company is speculative (Attorney General Reply Brief at 8).

Furthermore, the Attorney General asserts that, because the Petitioners' plans are to provide new services and products that will benefit the unregulated businesses and not traditional utility operations, the acquisition premium should be assigned solely to the unregulated entities (Attorney General Brief at 18; Attorney General Reply Brief at 10). The Attorney General asserts that the growth and expansion opportunities referred to by the Petitioners actually relate to areas that should be provided by unregulated businesses in the restructured gas industry, such as marketing of gas supplies, security services, energy services, and any bundled services (Attorney General Reply Brief at 10).

According to the Attorney General, the Petitioners have characterized the purpose of the merger as effecting a "strategic combination" and not designed to reduce Bay State's costs or its revenue requirement (Attorney General Brief at 18). Therefore, the Attorney General contends that the Department should deny the inclusion of the acquisition premium either directly in the cost to serve, or indirectly in the capital structure or for the purposes of the ESM (*id.*).

#### b. Petitioners

The Petitioners maintain that pooling of interests accounting is not an option for recording the merger transaction because NIPSCO Industries fails to meet the treasury stock condition of Accounting Principles Board Opinion No. 16 "Business Combinations" (36),(37) ("APB 16") as a result of its long-standing stock repurchase program (Petitioners Brief at 11). Furthermore, the Petitioners assert that pooling of interests accounting is not an option for recording the merger and, that therefore, the Attorney General's analysis of pooling of interests and dilution of book value is irrelevant (*id.* at 25). The Petitioners state that NIPSCO Industries' independent public accountant, Arthur Andersen, confirmed that the Petitioners must use purchase accounting to record the transaction (*id.* at 11-12).

The Petitioners contend that the Attorney General's earnings dilution analysis is illogical and lacks economic or accounting support (*id.* at 24-25). The Petitioners state that NIPSCO Industries' offer of \$40 for each outstanding share of Bay State stock is 2.35 times Bay State's book value (*id.* at 23). According to the Petitioners, this results in a total acquisition premium of \$310 million, of which approximately \$210 million would be apportioned to Bay State's Massachusetts operations (*id.*). Moreover, the Petitioners contend that the required annual amortization of this premium on Bay State's books under GAAP would be approximately \$5.4 million pre-tax and represents an additional revenue requirement of approximately \$9 million (Petitioners Brief at 12-13). The Petitioners argue that this required amortization would result in a significant dilution of Bay State's earnings, *i.e.*, approximately 30 percent (*id.*).

The Petitioners contend that the acquisition premium, even at 2.35 times Bay State's book value, is below the average premium paid in similar transactions (*id.* at 23). The Petitioners assert that NIPSCO Industries' stockholders would make this investment only if they have reasonable assurance to be repaid and an opportunity to earn a reasonable return on their investment (*id.*). The Petitioners argue that they are not asking Bay State customers to pay for any part of the acquisition premium as an immediate result of this proceeding.

The Petitioners acknowledge that Bay State will need to prove offsetting benefits before any part of the acquisition premium can be recovered in rates (Petitioners Reply Brief at 5). The Petitioners maintain that Bay State's rates will never be higher as a result of the merger (id.).

### 3. Analysis and Findings

The Department has stated that it will consider individual merger or acquisition proposals that seek recovery of an acquisition premium, as well as the recovery level of such premiums. Eastern-Essex Acquisition at 61, citing Mergers and Acquisitions at 18-19. Under the Department's standard, a company proposing a merger or acquisition must, as a practical matter, demonstrate that the costs or disadvantages of the transaction are accompanied by benefits that warrant their allowance. Thus, allowance or disallowance of an acquisition premium would be just one part (albeit an important one) of the cost/benefit analysis under the § 96 standard. Id.

As noted by the Department in Mergers and Acquisitions, under GAAP, a business combination seeking to use pooling of interests accounting must meet certain conditions. Mergers and Acquisitions at 10. Specifically, APB 16 requires that a business combination must satisfy 12 conditions to use pooling of interests accounting; and failure to satisfy even one of these conditions would require the combination to be recorded through purchase accounting (Exhs. Cos.-D at 3; AG 2-13; Tr. 2, at 51). The SEC has implemented a stringent policy of reviewing business combinations using pooling of interests accounting, requiring companies to restate their combinations under purchase accounting if the conditions in APB 16 are not fully met (Tr. 2, at 73-74). As part of this policy, the SEC has in place a presumptive rule that any stock repurchase undertaken by a company up to two years prior to a business combination was done for the purpose of the business combination (id. at 72-73). NIPSCO Industries' stock repurchase program, including those shares repurchased as a result of the IWC acquisition, renders these shares "tainted" for purposes of applying pooling of interests accounting. The "tainting" occurs because the number of shares NIPSCO has repurchased exceeds the SEC's definition of "normal" (id. at 52-54).<sup>(38)</sup> Moreover, the SEC's Staff Accounting

Bulletin 54<sup>(39)</sup> ("SAB 54"), the acquisition premium must be "pushed down" or recorded on the books of Bay State (Exh. AG 2-14). Both the Petitioners and Attorney General agree that the Treasury Stock Condition described in APB 16, as defined above, and the provisions of SAB 54 require the Petitioners to use purchase accounting to record the merger on Bay State's books.<sup>(40)</sup> The Department concludes that the use of purchase accounting for the proposed merger would comply with both GAAP and SEC regulations. Moreover, the Department concludes that the use of purchase accounting and the "push-down" of the acquisition premium on the books of Bay State would ensure that Bay State's books would more accurately indicate that company's post-merger financial condition (id.). Accordingly, the Department finds that the Petitioners' proposed use of purchase accounting to record the merger is appropriate.<sup>(41)</sup>

While the Attorney General acknowledges the need to record the merger on Bay State's books using purchase accounting, he proposes the use of an earnings dilution analysis based on pooling of interests accounting to determine the recoverable portion of the acquisition premium for regulatory purposes. The Attorney General argues that, had pooling of interests accounting been used, no acquisition premium would have resulted. However, the fact remains that pooling of interests accounting is not an option available to the Petitioners because of the Treasury Stock Condition. Therefore, the acquisition premium represents a real cost that must be recorded on Bay State's books. As noted in Section II.D, above, NIPSCO Industries is paying approximately \$550 million for assets with a book value of approximately \$240 million, with a resulting premium of \$310 million (Exh. AG 2-9). The amortization of the acquisition premium will occur over a period of years, with a corresponding effect on Bay State's balance sheet and earnings, as was demonstrated by the Attorney General's own witness (Exh. AG-1, Sch. DTE-1 at 2). The Attorney General's proposed accounting approach, if adopted, would effectively preclude recovery of an acquisition premium and thus would nullify any reason for NIPSCO Industries to consummate the merger. In Eastern-Essex at 70, the Department discussed how a company operating under cost-of-service regulation must be given an explicit opportunity to recover merger-related costs, including an acquisition premium, if beneficial mergers are to take place. In the long run, failure to complete the merger could be a detriment to Bay State ratepayers through lost economies that

could be realized by Bay State as part of a larger company. Therefore, the Department concludes that the acquisition premium presented by the Petitioners is a reasonable measure of the economic premium that occurs when using purchase accounting.

With respect to the Attorney General's argument that the acquisition premium should be passed back to Bay State's ratepayers as a gain on the sale of utility property, the Department notes that each of the cases cited by the Attorney General pertain to the sale or transfer of real property by a regulated utility. See Attorney General Reply Brief at 5-6. While the Attorney General has correctly noted the Department's policy with respect to gains on the sale of utility property, our policy presupposes that such properties have been recorded as above-the-line assets and that ratepayers have supported those assets through the utility's allowed rate of return. Barnstable Water Company, D.P.U. 93-223-B at 12-13 (1994); Commonwealth Electric Company, D.P.U. 88-135/151, at 90-92 (1989). A utility's rate base consists of assets that have been purchased through the issuance of stock or debt; and under well-established accounting and regulatory principles, stock and debt instruments do not constitute utility assets, but represent liabilities in the form of claims on those utility assets by the holders of those security instruments. See Charles F. Philips, Jr., The Regulation of Public Utilities 202 (2nd ed. 1985). Moreover, it is indisputable that, under the concept of original cost rate base, utility assets are carried on the utility's books at neither more nor less than their actual cost unless and until such assets are abandoned, replaced, reconstructed, or converted. 220 C.M.R. §§ 50.00 et seq., Gas Plant Instruction No. 2. Daily variations in a utility's stock value have no bearing on the value of the assets carried on the books of the utility.

There are no valid reasons to endorse the Attorney General's departure from well-established regulatory and accounting principles.

With respect to the level of consideration paid by NIPSCO Industries for Bay State, the record evidence demonstrates that the purchase price was evaluated in light of both a comparison with purchase prices associated with other recent mergers and acquisitions by LDCs, and an assessment of the potential long-term benefits (Exhs. Cos.-B at 19; AG 2-23; AG 3-3 at B1-3; AG 3-8, App. A (Proprietary)). A purchase price at a multiple of book value expresses a buyer's expectations of the acquired company's future contributions to combined operations. Eastern-Essex Acquisition at 64. The particular exchange rate involved in merger or acquisition stock transactions expresses a number of matters of value to the buyer, including a premium for management control and long-term strategic and economic value perceived by the buyer as accruing from the transaction. Id. It is clear that NIPSCO Industries, as a knowledgeable and willing buyer, experienced in other acquisitions, was prepared to pay a premium over Bay State's book value in exchange for long-term growth potential and to accept the risk associated with justifying, or not, the recovery of this premium at a later date

(Exhs. Cos.-B, at 11-13; AG 3-8, App. A (Proprietary); AG 3-10). Between 1994 and 1998, acquisition prices in natural gas distribution company mergers have ranged between 1.74 times and 5.56 times the book value of the acquired company, with an average of 2.68 times book value (Exh. AG 2-23).<sup>(42)</sup>

The proposed purchase price for Bay State's stock represents a premium of 2.35 times book value (Exh. AG 2-23). The price paid by NIPSCO Industries for Bay State in this case is well within the range of what has been offered in other transactions involving natural gas distribution companies (Exhs. Cos.-B at 19; AG 2-23; AG 3-8 (Proprietary)). Bay State's independent advisor, SG Barr Devlin, has pronounced the terms of the transaction to be reasonable (Exh. AG 3-3, at B-1 through B-3). The premium lies within an historic range and has been validated by the market at large and corroborated by independent financial advisors. The Department finds that the proposed purchase price for Bay State's common stock and proposed exchange ratio are in line with experience in other gas acquisitions and, therefore, are reasonable and valid expressions of today's market conditions. Cf. Haverhill Electric Company, D.P.U. 2138 (1926) (Department rejected proposed one-to-one stock exchange ratio, and found that a seven-to-ten exchange ratio was more reflective of the value of the acquired company).

The Department has stated that a § 96 petitioner seeking recovery of an acquisition premium cannot "rest its case on mere generalities, but must instead demonstrate benefits that justify the costs, including the cost of any premium sought." Eastern-Essex Acquisition at

10; Mergers and Acquisitions at 7. The Petitioners have chosen not to request recovery of an acquisition premium at this time, except to the extent that they would be allowed to use productivity gains over the five-year term of the rate freeze to offset the annual amortization of the acquisition premium during that time. The Petitioners have not quantified the expected benefits of the merger to offset the acquisition premium, primarily because the benefits of the merger are related to growth (which is too uncertain to estimate in quantifiable terms) and not cost-cutting (Petitioners Brief at 19). (Compare this to the Eastern-Essex Acquisition, a merger focused on cost cutting synergies, where the initial filing of the companies in that case quantified up-front all of the expected benefits, as directed by Mergers and Acquisitions at 7, and committed to a path that could be evaluated and approved by the Department in one event.) Instead, the Petitioners are relying on a requested Department finding that "Bay State may seek recovery of the annual amortization of the acquisition premium in future rate proceedings to the extent offset by merger-related savings." We find here that Bay State may seek recovery of the annual amortization of the acquisition premium in future rate proceedings to the extent offset by merger-related savings. In making this finding, however, we note that the Petitioners have chosen not to make their showing at this time that recovery of the premium is warranted but seek leave to make that showing later. The Petitioners thus voluntarily undertake the risk of later non-recovery of premium, if they fail to make the requisite showing of offsetting benefits. Mergers and Acquisitions made clear the terms for recovery, before the Petitioners proposed to postpone requesting recovery. Nevertheless, the Petitioners are currently incurring costs. This feature of the proposal is of the Petitioners' own choosing and not at the Department's insistence. Based on the evidence presented to date, the benefits claimed by the Petitioners have yet to be established to our satisfaction (Exh. AG 2-16 (Supp.); Tr. 2, at 146-147).

Despite the present lack of showing concerning premium recovery, the merger and Rate Plan have been structured so that Bay State's ratepayers are not at risk for recovery of any acquisition premium or merger-related costs during the five-year term of the rate freeze. Throughout this proceeding, the Petitioners have repeatedly represented that NIPSCO Industries' shareholders would bear any risk that the benefits and cost savings resulting from the merger would be insufficient to offset the acquisition premium (Tr. 2, at 129, 135-136; Petitioners Brief at 17; Petitioners Reply Brief at 3).

After the rate freeze, the Petitioners may seek recovery of the acquisition premium and merger-related costs from Bay State's ratepayers, provided that merger-related benefits are proven to the Department to be equal to or greater than any portion of the acquisition premium proposed to be included in base rates (Exh. Cos.-A at 21; Petitioners Brief at 24). At such time that the Petitioners seek to recover the acquisition premium through rates, they must show quantifiable benefits and be able to demonstrate, so as to warrant a reasonable conclusion, that such benefits are the result of the merger. This demonstration of merger-related benefits must be developed and maintained by the Petitioners on an on-going basis during the term of the rate freeze and thereafter until the Petitioners file their request for recovery of the acquisition premium and merger-related costs. The Department places the Petitioners on notice that we expect to see such documentation of merger-related savings as part of the demonstration of benefits that justify costs. Eastern-Essex Acquisition at 10; Mergers and Acquisitions at 7.

With respect to the amortization period of the acquisition premium, the Department has historically recognized that any acquisition premium would be, in general, amortized over the life of the acquired assets.<sup>(43)</sup> Mergers and Acquisitions at 12, citing Bay State Gas Company, D.P.U. 17726, at 5-6 (1973), Boston Gas Company, D.P.U. 17574, at 11 (1973), Boston Gas Company, D.P.U. 17138, at 7-8 (1971). The Petitioners propose to use rules established by GAAP in calculating the amortization period of the acquisition premium (Exh. DTE 1-15; Tr. 2, at 127). As stated by the Petitioners, a study will be completed after the consummation of the merger in order to ascertain the length of the amortization period as well as the allocation of the premium between Bay State and its subsidiaries (Tr. 2, at 127). The Department directs the Petitioners to submit a final copy of the study documenting the allocation and the amortization of the acquisition premium to the Department for review once such a study has been completed. Once such an allocation has been made, and Bay State has filed its proposed acquisition premium recovery method, the Department will consider the issue of the appropriate distribution of the acquisition premium among Bay State's regulated and unregulated operations.<sup>(44)</sup>

Based on the arguments and evidence, the Department finds that the acquisition premium of \$310 million as estimated by the Petitioners fairly represents the total acquisition premium that will result from the merger. Therefore, the Department finds that Bay State may seek recovery of the annual amortization of the acquisition premium in future proceedings to the extent offset by merger-related savings. As noted above, the Petitioners bear the burden of demonstrating the presence of merger-related benefits to the Department before any portion of this acquisition premium may be included in Bay State's rates. Because the stock exchange, when it occurs in fact, will be based on the actual number of Bay State shares outstanding on the consummation date as well as NIPSCO Industries' stock price used in the merger agreement, the actual amount of the acquisition premium cannot be precisely calculated until the consummation date or shortly thereafter -- although its range is formulaically determined. The Petitioners are hereby directed to provide the Department with a copy of the journal entries or a schedule summarizing such entries upon completion of the merger, in sufficient detail so as to determine the actual acquisition premium. Additionally, the Petitioners are directed to provide the Department with a detailed listing of the final transaction costs 90 days from the date of consummation of the merger.

Throughout this proceeding, the Petitioners have repeatedly represented that Bay State ratepayers would bear no risk for recovery of the acquisition premium during the five-year rate freeze (Tr. 2, at 129, 135-136; Petitioners' Brief at 17; Petitioners' Reply Brief at 3). This repeated representation is one to which NIPSCO Industries and Bay State will fairly be held throughout the period of the Rate Plan.

#### D. Financial Integrity of Post-Merger Gas Company

##### 1. Introduction

The Petitioners contend that the merger will have no adverse effects on Bay State's financial integrity and will provide Bay State with additional financing options under more favorable terms than are now available to that company (Petitioners Brief at 34). Petitioners claim that NIPSCO Industries' debt management program provides financing flexibility in such matters as terms and debt maturity. The debt management program is intended to allow ready responses to interest rate changes (Exh. AG 2-16 (supp) at 2).

##### 2. Analysis and Findings

The Department has stated that the financial integrity of a company may be one of the factors considered in evaluating a merger petition. Mergers and Acquisitions at 8-9. Under the Preferred Merger, Bay State would remain a stand-alone company operating as a wholly-owned subsidiary of NIPSCO Industries. A review of Bay State's financial and operating data, as represented by its annual returns to the Department,<sup>(45)</sup> SEC, and shareholders, as well as information provided in Bay State's disclosure statements and developed through NIPSCO Industries' evaluation of the proposed merger, demonstrates that Bay State is financially viable (Exhs. AG 1-1 (A); AG 1-2; AG 1-8; AG 3-9 (Proprietary)). Moreover, Bay State's post-merger financial position is likely to improve because of the additional sources of capital open to Bay State through its affiliation with NIPSCO Industries. Such an improvement would result in benefits to ratepayers (Exh. AG 2-16 (Supp.)). Accordingly, the Department finds that the Preferred Merger will not adversely affect Bay State's financial integrity, absent the effects of the deferral of recovery of the acquisition premium. See section IV C(3), above.

Under the Alternative Merger, Bay State would become a division of Northern Indiana. A review of Northern Indiana's financial and operating data contained in its annual reports to both the Federal Energy Regulatory Commission and the SEC, and a review of NIPSCO Industries' annual returns and disclosure statements provided to its shareholders, demonstrates that Northern Indiana is also financially viable (Exhs. AG 1-1 (B); AG 1-3; AG 1-7; AG 1-9). There is no evidence that Northern Indiana's or Bay State's facilities require extraordinary investments, or that the financial viability of either company is in doubt. Cf. Community Utilities/Resort Supply, D.P.U. 16380, at 2-5 (1970) (Department disallowed proposed merger of two small water systems because of, in part, concerns over the financial viability of both systems). Finally, Bay State's ratepayers may benefit through NIPSCO Industries' additional sources of

capital available to Northern Indiana (Exh. AG 2-16 (Supp.)). Accordingly, the Department finds that the Alternative Merger will not adversely affect Bay State's financial integrity.

## E. Societal Costs

### 1. Introduction

The Petitioners stated that in considering the merger, they did not seek a combination that would require employee reductions at either Bay State or NIPSCO Industries in order to generate lower costs and greater short-term earnings (Exh. Cos.-A, at 13; Cos.-B at 11). Instead, the Petitioners view the acquisition of Bay State by NIPSCO Industries as a "strategic merger" that would use Bay State's existing workforce to increase throughput and improve service to customers (Exhs. Cos.-A at 13; Cos.-B at 13). The Petitioners stated that under both the Preferred Merger and Alternative Merger, Bay State would maintain its Westborough headquarters, as well as its existing local offices in Brockton and Springfield (Tr. 2., at 97). The Petitioners noted that although any consideration of workforce reductions here would be premature, future workforce reductions that may occur as a result of cost containment efforts would be worked out through negotiation with the employees' respective bargaining units (Tr. 2, at 100). The intervenors did not address this issue on brief.

### 2. Analysis and Findings

The Department does not lightly regard the effect of mergers on employment. Eastern-Essex Acquisition at 44. Although job redundancies in consolidated systems would impose avoidable costs and thus would be detrimental to ratepayers, the Department has noted that the elimination of these redundancies should be accomplished in a way that mitigates the effect on the utility's employees. Eastern-Essex Acquisition at 43.

Bay State has already engaged in significant cost containment efforts, and savings have resulted from workforce reductions (Exh. Cos.-B at 11-12; Tr. 2, at 94, 97-99). Moreover, NIPSCO Industries' assessment of the growth potential in Bay State's service territory and expressed intent to avoid layoffs at Bay State demonstrate that the Petitioners consider a strong local presence and management at Bay State to be a critical component of the combined system's long-term objectives (Exh. Cos.-B at 13; Tr. 2, at 94-95). The Department concludes that neither the Preferred Merger nor the Alternative Merger would significantly affect Bay State's workforce.

## F. Stock Issuance

### 1. Introduction

Acquisition Company is intended to have an authorized capitalization of 1,000 shares of common stock, \$1.00 par value, of which 100 shares have been subscribed for sale to NIPSCO Industries at a price of \$1.00 per share (Exh. DTE 1-7 (Supp.)). The Petitioners request that the Department authorize and approve the proposed issuance of 100 shares of this common stock to NIPSCO Industries, at a price of \$1.00 per share (Petition at 1). The Petitioners state that the proposed issuance is reasonably necessary to effect the merger (*id.* at 6). While the Petitioners restated their request in their brief, the Attorney General did not address this issue on brief.

### 2. Standard of Review

In order for the Department to approve the issuance of stock, bonds, coupon notes, or other types of long-term indebtedness<sup>(46)</sup> by an electric or gas company, the Department must determine that the proposed issuance meets two tests. First, the Department must assess whether the proposed issuance is reasonably necessary to accomplish some legitimate purpose in meeting a company's service obligations, pursuant to G.L. c. 164, § 14. Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 395 Mass. 836,

842 (1985) ("Fitchburg II"), citing Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 394 Mass. 671, 678 (1985) ("Fitchburg I"). Second, the Department must determine whether the Company has met the net plant test.(47) Colonial Gas Company, D.P.U. 84-96 (1984).

The Court has found that, for the purposes of G.L. c. 164, § 14, "reasonably necessary" means "reasonably necessary for the accomplishment of some purpose having to do with the obligations of the company to the public and its ability to carry out those obligations with the greatest possible efficiency." Fitchburg II at 836, citing Lowell Gas Light Company v. Department of Public Utilities, 319 Mass. 46, 52 (1946). In cases where no issue exists about the reasonableness of management decisions regarding the requested financing, the Department limits its Section 14 review to the facial reasonableness of the purpose to which the proceeds of the proposed issuance will be put. Canal Electric Company, et al., D.P.U. 84-152, at 20 (1984); see, e.g., Colonial Gas Company, D.P.U. 90-50, at 6 (1990).

The Fitchburg I and II and Lowell Gas cases also established that the burden of proving that an issuance is reasonably necessary rests with the company proposing the issuance, and that the Department's authority to review a proposed issuance "is not limited to a 'perfunctory review.'" Fitchburg I at 678; Fitchburg II at 842, citing Lowell Gas at 52.

Where issues concerning the prudence of a company's capital financing have not been raised or adjudicated in a proceeding, the Department's decision in such a case does not represent a determination that any specific project is economically beneficial to a company or to its customers. In such circumstances, the Department's Order may not in any way be construed as ruling on the appropriate ratemaking treatment to be accorded any costs associated with the proposed financing. See, e.g., Boston Gas Company, D.P.U. 95-66, at 7 (1995).

Regarding the net plant test, a company is ordinarily required to present evidence that its net utility plant (original cost of capitalizable plant less accumulated depreciation) is equal to or exceeds its total capitalization (the sum of its long-term debt, preferred stock, and common stock outstanding) and will continue to do so after the proposed issuance.

D.P.U. 84-96, at 5. If the Department determines at that time that the fair structural value of the net plant and land and the fair market value of the nuclear or fossil fuel inventories owned by the company are less than its outstanding debt and stock, it may prescribe such conditions and requirements as it deems best to make good within a reasonable time the impairment of the capital stock. G.L. c. 164, § 16.

### 3. Analysis and Findings

The Petitioners have requested that the Department authorize the issuance of stock to a corporation that is not yet in existence. While one could argue that G.L. c. 164, § 14, addresses stock transfers to corporate entities only, we recognize that some flexibility must be afforded to those petitioners that require stock transfers in order to form a corporation by way of a merger or acquisition. Here, the Petitioners request authority to issue stock in order to establish the framework within which the merger could be consummated. Without the authority to issue the stock, this merger would not take place. Therefore, the Department finds that the issuance of 100 shares of common stock by Acquisition Company, at a par value of \$1.00, is a necessary mechanism for the purpose of forming Acquisition Company and effecting the proposed merger. Accordingly, the Department finds that the proposed stock issuance is reasonably necessary and is in accordance with G.L. c. 164, § 14.

With regard to the net plant test requirement of G.L. c. 164, § 16, the record demonstrates that Acquisition Company has no assets and thus could not meet the net plant test as contemplated by G.L. c. 164, § 16. However, the Department notes that the Merger Agreement would extinguish the corporate existence of Bay State. Through the acquisition of Bay State's assets, Acquisition Company would remedy any net plant deficiency of Acquisition Company. See Eastern-Essex Acquisition at 74; D.P.U./D.T.E 97-63, at 73. The

purpose of the net plant test is to protect investors from hidden watering of stock. Application of the test was not contemplated for a transaction as patent and transparent as the instant one. No public protective purpose would be served by applying the test here. It is sufficient to note that the transaction is structured to prevent any adverse risk to the investing public and immediately to correct any theoretical problem with the Acquisition Company shares. Eastern-Essex Acquisition at 74. Therefore, the Department finds it unnecessary to impose further conditions upon Acquisition Company under G.L. c. 164, § 16.

#### G. Section 17A Approval of Funds Pooling Amendment

##### 1. Introduction

In Bay State Gas Company, D.P.U. 96-69 (1996), the Department approved a funds pooling arrangement between Bay State, Northern, and Granite State, in which the participants pool their short-term cash surpluses and manage these funds to meet the borrowing needs of the participants (Exh. DTE 1-22). The Petitioners request approval of a modification to Bay State's funds pooling agreement to permit NIPSCO Capital, NIPSCO Industries' financing subsidiary, to participate (Petition at 6; Tr. 2, at 75).[\(48\)](#)

##### 2. Standard of Review

Pursuant to G.L. c. 164, § 17A, a gas or electric company must obtain written Department approval in order to "loan its funds to, guarantee or endorse the indebtedness of, or invest its funds in the stock, bonds, certificates of participation or other securities of, any corporation, association or trust." The Department has required that such proposals must be "consistent with the public interest," that is, a Section 17A proposal will be approved if the public interest is at least as well served by approval of the proposal as by its denial. Bay State Gas Company, D.P.U. 91-165, at 7 (1992); see D.P.U. 850, at 7-8.

The Department has stated that it will interpret the facts of each Section 17A case on their own merits to make a determination that the proposal is consistent with the public interest. D.P.U. 91-165, at 7. The Department will base our determination on the totality of what can be achieved by, rather than on a determination of any single gain that could be derived from, the proposed transaction. Id.; see D.P.U. 850, at 7. Thus, the Department's analysis must consider the overall anticipated effect on ratepayers of the potential costs and benefits of the proposal. D.P.U. 91-165, at 8. The effect on ratepayers may include consideration of a number of factors, including, but not limited to: the nature and complexity of the proposal; the relationship of the parties involved in the underlying transactions; the use of funds associated with the proposal; the risks and uncertainties associated with the proposal; the extent of regulatory oversight on the parties involved in the underlying transaction; and the existence of safeguards to ensure the financial integrity of the utility. Id.

##### 3. Analysis and Findings

As part of the Department's approval of Bay State's funds pooling agreement in

D.P.U. 96-69, the Department required that any amendment in the funds pooling agreement be approved by the Department prior to its implementation. D.P.U. 96-69, at 4-5. The Department has approved amendments to other funds pooling agreements, including the addition of additional participants to these fund pools. Nantucket Electric Company, D.P.U. 95-67, at 15-16 (1995); Massachusetts Electric Company, D.P.U. 91-133, at 4 (1992); New England Power Company, D.P.U. 88-166, at 2 (1989).

As noted in Section I (see note 2, above), NIPSCO Capital provides financing for most of NIPSCO Industries' regulated and unregulated subsidiaries under the terms of a support agreement ("Indiana Agreement") (Exh. Co.-B, Sch. MTM-2, at 26; Tr. 2, at 75).

The Petitioners requested the inclusion of NIPSCO Capital in Bay State's funds pooling agreement, rather than the addition of Bay State and its subsidiaries as participants to NIPSCO Capital's current Indiana Agreement (Tr. 2, at 78). The Petitioners consider the Bay State funds pooling agreement to be more adaptable to Bay State's post-merger operations (Tr. 2, at 78). NIPSCO Capital currently has a \$150 million revolving-credit agreement, that provides short-term financing flexibility to NIPSCO Industries' subsidiaries, plus \$130 million in money market lines of credit (Exh. Co.-B, Sch. MTM-2, at 26). The addition of NIPSCO Capital as a participant to Bay State's funds pooling agreement would provide Bay State with the opportunity to gain access to these additional financing sources to meet its short-term borrowing needs. Conversely, given the status of NIPSCO Capital as a financing vehicle, NIPSCO Capital's own borrowings from the Bay State pool would be negligible. Therefore, the Department concludes that the proposed amendment to Bay State's funds pooling agreement, which will permit NIPSCO Capital to participate in the funds pooling agreement, is consistent with the public interest.

If the Alternative Merger is consummated, Northern Indiana would be the surviving company, with Bay State operating as a division of Northern Indiana (Exhs. Co.-A at 28-29; Co.-B, Sch. MTM-4, at A-1). Although Northern Indiana is not currently a participant in the Support Agreement (Tr. 2, at 75-76), by virtue of the Alternative Merger, Northern Indiana would be the successor in interest to all rights, privileges, immunities, and powers currently held by Bay State (Exh. Cos.-B, Sch. MTM-4, at A-1). Accordingly, the Department finds that if the Alternative Merger is ultimately implemented, Northern Indiana would become a participant in the funds pooling agreement.

The Petitioners stated that NIPSCO Industries' management is still evaluating the possibility of including Northern Indiana as a participant to the Indiana Agreement (Tr. 2, at 78-80). If the Alternative Merger is ultimately implemented, and NIPSCO Industries' management determines that it would be appropriate to include Northern Indiana as a participant to the Indiana Agreement, Department approval of Northern Indiana's inclusion may also be required under G.L. c. 164, § 17A. Therefore, the Petitioners are directed to notify the Department if NIPSCO Industries implements the Alternative Merger and later seeks to include Northern Indiana as a participant to the Indiana Agreement.

#### H. Northern Indiana Operating as a Massachusetts Gas Company

##### 1. Introduction

Northern Indiana is an Indiana corporation organized as a combination gas and electric company doing business exclusively in Indiana (Exhs. Co.-B at 3; AG 1-1, Sec. 4.3, at 3). According to the Petitioners, G.L. c. 164, § 8A(a)(49) suggests that Northern Indiana may need Department approval to operate as a gas company in Massachusetts because of its status as an electric company in Indiana (Petition at 4). Therefore, Northern Indiana has requested authorization to engage in the business of a gas company in Massachusetts if the Alternative Merger is ultimately consummated (Petition at 7; Tr. 2, at 80-81). (50) The Petitioners stated that Northern Indiana does not intend to operate as a Massachusetts gas company if the Preferred Merger is ultimately implemented (Tr. 2, at 80-81). The Petitioners stated that, although Northern Indiana has not yet taken the required shareholder vote to amend its articles of organization, obtaining shareholder approval would not be difficult in view of Northern Indiana's status as a wholly-owned subsidiary of NIPSCO Industries (Tr. 2, at 81-83).

##### 2. Standard of Review

In pertinent part, G.L. c. 164, § 8A, requires the Department, after notice and public hearing, to certify to the secretary of state that the public convenience will be promoted, permitting Northern Indiana to operate as a gas company in Massachusetts.

Because the statute does not define "public convenience," the Department relies on our precedents relating to "public convenience and necessity."

The Department has been accorded wide discretion in determining whether the "public convenience and necessity" would be promoted by some proposed action. Zacks v. Department of Public Utilities, 460 Mass. 217 (1985) Almeida Bus Lines, Inc. v. Department of Pub. Utils., 348 Mass 331 (1965); Holyoke St. Ry. v. Department of Pub. Utils., 347 Mass. 440 (1964); Newton v. Department of Pub. Utils., 339 Mass. 535 (1959). "Public convenience and necessity" is a term of art that the courts have equated with "public interest". Zacks v. Department of Public Utilities, 460 Mass. 217, 223 (1985). Therefore, to determine whether to authorize a gas company to engage in the business of an electric company, or an electric company to engage in the business of a gas company, the Department will consider whether the requested action is in the public interest.

### 3. Analysis and Findings

Petitions under this statute and its predecessors<sup>(51)</sup> have historically been brought by gas companies seeking to operate electric systems. See, for example, Cambridge Gas Light Company, D.P.U. 3729 (1930). While the earlier G.L. c. 164, § 23, was replaced by certain provisions of G.L. c. 164, § 8A, no petitions under either the pre-1973 version of § 23 or the later § 8A have been filed with the Department since 1930. Moreover, Department records indicate that this is the first time that a non-Massachusetts gas or electric company (as distinct from common carriers) has sought to acquire or merge with a Massachusetts utility (holding companies, of course, are distinct). Thus, the matter before us is one of first impression.

The entrance of foreign corporations in the Massachusetts gas and electric industries previously raised concerns over the legal status of foreign corporations operating gas and electric systems within Massachusetts; and foreign ownership was not favored. Third Annual Report of the Board of Gas and Electric Light Commissioners at 58 (1888). The enactment of the Restructuring Act<sup>(52)</sup> ("Act") revised the definition of a "gas company" or "electric company" set out in G.L. c. 164, § 1, to include non-Massachusetts corporations operating gas or electric utilities within Massachusetts.<sup>(53)</sup> The Act gives the Department the same jurisdiction over foreign utilities operating in Massachusetts as is currently applied to Massachusetts-chartered corporations. Therefore, there is no longer a bar on "foreign" corporations operating gas or electric systems within Massachusetts. The Department considers that approval of Northern Indiana's request to operate as a Massachusetts gas utility would facilitate a contingency merger proposal that has been found to be consistent with the public interest. Because the Department has equated "public interest" with "public convenience," for the reasons described above, the Department finds that the public convenience would be promoted by an amendment to Northern Indiana's articles of incorporation that would permit it to operate as a gas utility in Massachusetts.

Northern Indiana's articles of incorporation currently restrict that company to operating only within Indiana (Exh. AG 1-1, Sec. 4.3, at 3). Although Northern Indiana has not yet made the shareholder vote necessary under § 8A to permit operations in Massachusetts, the Petitioners represent that the required vote will be readily obtained because Northern Indiana is a wholly-owned subsidiary of NIPSCO Industries (Tr. 2, at 81-83). Because § 8A does not require that the shareholder vote take place prior to Department certification, the Department finds that approval may be granted, contingent upon the required vote of Northern Indiana's sole shareholder, NIPSCO Industries and accordingly, gives this approval. The Petitioners are directed to submit a copy of the shareholder vote to amend Northern Indiana's articles of organization and revised articles of organization, if and when such a vote is taken.<sup>(54)</sup>

Northern Indiana's request to operate as a Massachusetts gas company also raises the issue of the corporate name under which Northern Indiana would operate. G.L. c. 164, § 5A, requires that the name of a utility corporation operating in Massachusetts contain the words "gas company" or "electric company," as the case may be. The Petitioners indicated that, if the Alternative Merger is ultimately implemented, Northern Indiana would operate in Massachusetts under a d/b/a arrangement as "Bay State Gas Company" in order to capitalize on customer familiarity with Bay State and thereby avoid customer confusion (Tr. 2, at 86). Based on a review of G.L. c. 156B and c. 164, the Department concludes that there is no statutory bar against the use of an assumed name by Northern

Indiana.<sup>(55)</sup> Additionally, the Department finds that the continued use of the Bay State corporate name by Northern Indiana for its potential Massachusetts operations would reduce the possibility of customer confusion resulting from the merger. Accordingly, the Department finds it appropriate for Northern Indiana to operate under Bay State's name, if the Alternative Merger is ultimately consummated.

Northern Indiana would only operate as a Massachusetts gas company if the Alternative Merger is implemented (Tr. 2, at 80-81). If the Preferred Merger is ultimately implemented, Northern Indiana's need to operate as a Massachusetts gas company would be rendered moot (Tr. 2, at 68). The Petitioners themselves have made the request for Northern Indiana to operate as a Massachusetts gas utility only to facilitate an Alternative Merger proposal

(Exh. Cos.-A, Sch. MTM-4, at A-1; Tr. 2, at 80-81). Therefore, the Department's approval of Northern Indiana's request to operate as a Massachusetts gas utility is contingent upon the consummation of the merger under the Alternative Merger proposal.

In view of the possibility that the Preferred Merger may be ultimately implemented, the Department finds it appropriate to place a time limit on the authority being granted by this order to Northern Indiana. See Berkshire Gas Company, D.P.U. 16090, at 3 (1969). The Department places the Petitioners on notice that Northern Indiana's authorization to operate as a gas company in Massachusetts shall expire as of the date of the consummation of the Preferred Merger, if the Preferred Merger is implemented.

#### I. Preferred Merger Versus Alternative Merger

While the Petitioners are seeking approval of both the Preferred Merger and Alternative Merger, they have expressed their preference for the Preferred Merger and request that the Department inform the SEC that the Department also favors the Preferred Merger (Exh. Cos.-B at 17; Petition at 3).

The Department favors the Preferred Merger. Under the Preferred Merger, the post-merger structure of Bay State would be consistent with the holding company structures that have been adopted by all of the investor-owned Massachusetts-based electric utilities, a number of investor-owned gas utilities, and are currently under consideration by other utilities. Eastern-Essex Acquisition at 76-77; D.P.U. 97-63, at 10; Berkshire Gas Company, D.T.E. 98-61 (pending before the Department). The Alternative Merger would make Bay State an operating division of Northern Indiana, a wholly-owned gas and electric subsidiary of NIPSCO Industries, a holding company. Under the Preferred Merger, Bay State would have its own books and records, capital and management structures, and board of directors (Exh. Cos.-A at 29-30). Therefore, the Department's statutorily-mandated review of specific company proposals would be more efficient under the Preferred Merger than the Alternative Merger, where Bay State would be operating as the Massachusetts division of Northern Indiana.

By way of example, G.L. c. 164, § 14 requires gas and electric companies to seek Department approval prior to the issuance of stock, bonds, coupon notes, or other evidences of indebtedness. Under the Preferred Merger, the Department's review of financing proposals filed by Bay State pursuant to G.L. c. 164, § 14, would be based on examining Bay State as a stand-alone entity or as a participant in a larger financing package prepared by NIPSCO Industries (Tr. 2, at 65-66). Under the Alternative Merger, the Department would have to examine each financing proposal of Northern Indiana, whether or not the financing had any effect on that company's Massachusetts division, in order to determine whether the particular proposal had an impact on Massachusetts operations (Tr. 2, at 66-67). As the Petitioners have noted, implementation of the Alternative Merger would require additional coordination between the Department and the Indiana Utility Regulatory Commission, thereby adding to the complexity of financial oversight (Tr. 2, at 67-68). Moreover, complexities would be created in the area of cost allocations between Northern Indiana's Indiana and Massachusetts operations (Exhs. AG 3-11; AG 3-12). Therefore, because of the efficiencies that would result from the Preferred Merger, the Department states its pronounced preference for the Preferred Merger over the Alternative Merger.

The Petitioners have also proposed an Alternative Merger (Tr. 2, at 68, 81-82;

Exh. Cos.-A, Sch. MTM-4, at A-1).<sup>(56)</sup> The Department has already spoken in favor of the Preferred Merger model and has noted that, with the exception of differing corporate structures, the remaining elements of the Preferred and Alternative Merger proposals are identical. If the Alternative Merger model is followed, Bay State (a gas company within the meaning of

G.L. c. 164, sec. 1, and a Massachusetts corporation) would merge not into Acquisition Company, a planned Massachusetts corporation, but, instead, into Northern Indiana, an existing gas and electric company incorporated in Indiana. The Alternative Merger would thus extinguish Bay State's corporate existence under Massachusetts law. The company would be converted into the Massachusetts operating division of the foreign corporation, Northern Indiana.

The Electric Restructuring Act, St. 1997, c. 164, § 189 ("Restructuring Act"), amended the definition of "gas company" in G.L. c. 164, § 1, to remove the requirement that a gas company be organized under the laws of the Commonwealth. It seems evident that the Legislature's removal of that restriction was intended to permit foreign corporations to act as gas companies in Massachusetts. The result was to allow operation by entities previously excluded from Massachusetts regulatory law and practice. The Restructuring Act contains, however, no further expression of legislative intent as to how regulation of such foreign corporations -- and certainly not foreign corporations with operating divisions in both Massachusetts and other

states -- is to be accomplished under or integrated into G.L. c. 164. Moreover, apart from requesting approval of the Alternative Merger proposal, the Petitioners developed no adequate record on how certain regulatory questions raised by that proposal ought to be addressed or how Bay State would conduct itself as an operating division of Northern Indiana.

There are important issues about regulating Bay State as an operating division of a foreign corporation. These issues include the nature and scope of Department regulation of Northern Indiana's capital structure, cost allocation between operating divisions,<sup>(57)</sup> and the coordination between this Department and the Indiana Utility Regulatory Commission. These and probably other issues may need to be defined, explored, and resolved in the interest of protecting Bay State ratepayers.

Having made those points, the Department provisionally approves the contingent Alternative Merger. If the Petitioners elect to follow that path, instead of the Preferred Merger, then the Petitioners must so inform the Department and must file with the Department

proposals -- with supporting legal argument -- for appropriate integration of the Alternative Merger's corporate and operating structure into the G.L. c. 164 framework. The Petitioners, either through the initial filing or through a Department investigation, must satisfy the Department that Massachusetts ratepayers' interest will not be impaired.

## V. SUMMARY

The Department has evaluated the benefits and costs associated with the merger based on the following five factors: (1) effect on rates and the resulting net savings the merger; (2) effect on the quality of service; (3) societal costs; (4) acquisition premium; and (5) financial integrity of the post-merger entity.

The Department has found that approval of a five-year base rate freeze will benefit Bay State's ratepayers and will result in just and reasonable rates. Further, the Department recognized that the proposed merger could provide Bay State's ratepayers with savings in gas costs that would be unavailable absent the merger.

Concerning the proposed merger's effect on quality of service, the Department has ordered the continuation of the quality of service plan currently in effect to ensure that Bay State's ratepayers experience no degradation of service following the merger.

With respect to the societal costs of the proposed merger, the Department has found that the merger would not significantly affect Bay State's workforce.

Regarding the recovery of an acquisition premium, the Department has found that earnings dilution to Bay State's shareholders that results from the merger represents a cost that may and should be taken into consideration as part of the evaluation of the costs and benefits of the merger. The Department found that the proposed purchase price for Bay State's common stock and proposed exchange ratio are reasonable. Therefore, the Department accepted the Petitioners' estimate of \$ 310,000,000 for the acquisition premium and has found it to be reasonable. However, the Department reminds the Petitioners that they are at risk for non-recovery of the premium if they fail to make the requisite showing of offsetting benefits.

Regarding the financial integrity of the post-merger entity, the Department has found that both Bay State and Northern Indiana are viable companies and that the merger would not adversely affect Bay State's financial integrity.

Based on our evaluation of the costs and benefits associated with the aforementioned factors, the Department finds that the public interest would be at least as well served by approval of the proposed merger as by its denial, *i.e.*, that there is no net harm to ratepayers. Therefore, the proposed merger is consistent with the public interest. Accordingly, the Department hereby approves the Preferred and Alternative Merger Agreements and Rate Plan, subject to the directives contained herein, under the terms of G.L. c. 164, §§ 94 and 96.

## VI. CONCLUSION

For decades, little or no acquisition or merger activity took place in the Commonwealth. Service territory maps of investor-owned electric and gas companies in Massachusetts, as a result, remain highly Balkanized.<sup>(58)</sup> Such geographic fragmentation suggests inefficiencies both from avoidable overhead and from limitations on utilities' ability to take market actions beneficial to customers -- especially in the area of gas purchasing, corporate finance, and staffing. Mergers and Acquisitions, D.P.U. 93-167A, sought to break with this disadvantageous *status quo*. Eastern-Essex Acquisition, D.T.E. 98-27, enunciated a clear Department policy in favor of suitably-framed consolidations. The Petitioners, however, filed shortly after the Eastern-Essex transaction came before the Department and thus could not have benefitted from perusal of the final order in Eastern-Essex Acquisition before making their filing.

While the proposal made in the instant docket has succeeded in securing Department approval under §96, the Petitioners' initial filing lacked the detail we expect to see in future §96 proposals. The logic of the initial filing had its strengths; but the filing's level of generality left important detail to be developed by the Department itself through discovery and evidentiary hearings. The Department would not want to repeat that onerous process.

Mergers and Acquisitions, D.P.U. 93-167A, at 7, had warned that a petitioner who expects to avoid an adverse outcome should not rest its case on mere generalities. The Department would not want future petitioners to see its approval of the instant proposal as a sign that this initial filing is a favored model for future §96 filings. Future filings, based on generalities, will not suffice to justify § 96 approval, including any requests for acquisition premium recovery. This reminder applies also to any future filing by the instant Petitioners to justify premium recovery. Rather, the Petitioners must demonstrate benefits that justify costs, including the cost of any acquisition premium sought.

## VII. ORDER

Accordingly, after due notice, hearing and consideration, the Department

VOTES: That pursuant to G.L. c. 164, § 14, the issuance and sale by Acquisition Gas Company of 100 shares of common stock, \$1.00 par value, to NIPSCO Industries in exchange for \$100.00 is reasonably necessary for the purposes stated; and it is

ORDERED: That pursuant to G.L. c. 164, § 14, the issuance and sale by Acquisition Gas Company of 100 shares of common stock, \$1.00 par value, to NIPSCO Industries in exchange for consideration of \$100.00 is hereby approved and authorized; and it is

FURTHER ORDERED: That pursuant to G.L. c. 164, § 96, the Agreement and Plan of Merger by and among Bay State and NIPSCO Industries, dated as of December 18, 1997, and as amended and restated as of March 4, 1998, by and between Bay State and NIPSCO Industries is hereby approved; and it is

FURTHER ORDERED: That pursuant to G.L. c. 164, § 96, the merger of Acquisition Gas Company into Bay State Gas Company is hereby approved; and it is

FURTHER ORDERED: That pursuant to G.L. c. 164, § 94, the Rate Plan for Bay State Gas Company is allowed in part and denied in part, and that Bay State Gas Company, Northern Indiana Public Service Company and NIPSCO Industries design and file a Rate Plan in compliance with this Order; and it is

FURTHER ORDERED: That, upon consummation of the Preferred Merger of Acquisition Gas Company with and into Bay State Company, Acquisition Gas Company as surviving company shall have all rights, powers, and privileges, franchises, properties, real personal or mixed, and immunities held by Bay State Gas Company necessary to engage in all the activities of a gas utility company in all the cities and towns in which Bay State Gas Company was engaged immediately prior to the merger, and that further action pursuant to G.L. c. 164, § 21 is not required to consummate the merger; and it is

FURTHER ORDERED: That pursuant to G.L. c. 164, § 17A, under the Preferred Merger, an amendment to Bay State's debt pooling agreement to join NIPSCO Capital Markets, Inc. as a party to the Agreement is hereby approved; and it is

FURTHER ORDERED: That if, subject to the conditions contained herein, the Alternative Merger occurs, operation of Northern Indiana as a gas company is approved pursuant to G.L. c. 164, §§ 1 and 8A(a); and it is

FURTHER ORDERED: That Bay State Gas Company, NIPSCO Industries, Northern Indiana Public Service Company and Acquisition Gas Company shall comply with all directives contained herein; and it is

FURTHER ORDERED: That a copy of the journal entries, or a schedule summarizing such entries, recording the effect of the merger shall be filed with the Department upon consummation of the merger; and it is

FURTHER ORDERED: That the Secretary of the Department notify the Secretary of State of the issuance of stock and deliver a certified copy of this Order to the Secretary of State within five business days hereof; and it is

FURTHER ORDERED: That the Secretary of the Department notify the securities and Exchange Commission of the issuance of this Order under cover letter informing that agency of the Department's preference for the Preferred merger, and deliver to that agency a certified copy of this Order.

By Order of the Department,

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Janet Gail Besser, Chair

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James Connelly, Commissioner

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W. Robert Keating, Commissioner

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Paul B. Vasington, Commissioner

Eugene J. Sullivan, Jr., Commissioner

1. The draft articles of organization for NIPSCO Acquisition Company identify the company as Acquisition Gas Company (Exh. DTE 1-7). The Petitioners stated that the latter name will be used when the subsidiary actually is incorporated (Tr. 2, at 84).

2. NIPSCO Capital acts as a financing agent for all of NIPSCO Industries' regulated and unregulated subsidiaries, with the exception of Northern Indiana, under the terms of an existing support agreement (Exhs. Cos.-B, Sch. MTM-2, at 26, 35; DTE 1-23; Tr. 2, at 75).

3. On June 25, 1998, the Union filed a letter in support of the Merger.

4. See note 6 below.

5. Through IWC, NIPSCO Industries indirectly owns Indianapolis Water Company and Harbor Water Corporation, plus three unregulated subsidiaries (Exh. Cos.-B at 4).

6. The Petitioners explain that while they have requested that the SEC approve the Preferred Merger, they note that the SEC may, as a condition of the Preferred Merger, require NIPSCO Industries to relinquish its status as an exempt holding company by virtue of Section 3(a)(1) of the Public Utility Holding Company Act of 1935 ("PUHCA") (Exh. Cos.-B at 16). Loss of the exempt status would, according to the Petitioners, impose significant reporting requirements on NIPSCO Industries, as well as possible restrictions on NIPSCO Industries' operations (Tr. 2, at 59-62). Because the Alternative Merger does not require SEC approval, the Petitioners request that the Department approve the merger under both the Preferred Merger and the Alternative Merger, so that the merger may be consummated under the Alternative Merger if the SEC requires NIPSCO Industries to relinquish its exempt status as a condition of approval of the Preferred Merger (Exhs. Cos.-A at 29; Cos.-B at 16). The Petitioners made the request that the Department inform the SEC of a preference for the Preferred or the Alternative Merger plan in advance of our final order in D.T.E. 98-31

(Exh. Cos.-A, Tab A at 4). Of course, such a prejudgment in advance of a final Order is not a request that the Department could readily grant. But we do state here that the Preferred merger is favored by the Department and will so inform the SEC. See § VII below.

7. The actual number of NIPSCO Industries' shares to be issued in exchange for Bay State's common stock would be determined by dividing the cash price of \$40 per share by the average NIPSCO closing price for the twenty trading days before the second trading day before the consummation of the merger (the "Effective Time" as described in article 1.4 of the merger agreement (Exh. Cos.-B, Sch. MTM-4, at A-3).

8. Earnings sharing refers to a sharing of above- or below-average profits between the utility and ratepayers. Under earnings sharing, the regulator sets a benchmark return using traditional Rate of Return techniques. The regulator then establishes the level(s) of return above and below the benchmark at which sharing would be triggered, and the distribution of those above- or below-average earnings between the utility and ratepayers. NYNEX, D.P.U. 94-50 at 186 (1994).

9. In Bay State Gas Company, D.P.U. 97-97 (1997), the Department approved a settlement agreement between Bay State and the Attorney General which provided for two annual base rate increases of up to \$1.8 million per year, recovery of an additional \$1.6 million for expenses related to customer choice pilot programs through the Distribution Adjustment Cost Clause, and the introduction of both an ESM and service quality index.

10. According to the Petitioners, the actual premium level attributable to Bay State's stand-alone operations is dependent upon a number of factors, including a review of Bay State's accounts, the final costs of the transaction, and the elections made by Bay State's

shareholders under the cash option feature (Tr. 1, at 23-26; Tr. 2, at 123). The Petitioners agreed that for purposes of the proceedings, they would accept the Attorney General's estimate that Bay State's stand-alone share of the total acquisition premium would be 69.7 percent, or \$216,096,000 (Exh. DTE-1, Sch. 1; Tr. 1, at 24-26).

11. Those transaction costs being incurred by Bay State are expensed in accordance with GAAP (Exh. AG 2-14).

12. The Department issued its Order in Eastern-Essex Acquisition, D.T.E. 98-27 (1998) on September 17, 1998, which was after hearings were completed and briefs had been filed in this case.

13. The Department notes that a finding that a proposed merger or acquisition would probably yield a net benefit does not mean that such a transaction must yield a net benefit to satisfy G.L. c. 164, § 96 and Boston Edison, D.P.U. 850.

14. Thus, Mergers and Acquisitions removed the per se bar to recovery of acquisition premiums and treated them as just another kind of costs to be reckoned in the balancing of costs and benefits required by G.L. c. 164, § 96 and Boston Edison Company, D.P.U. 850.

15. In their Brief, the Petitioners indicated, for the first time, a willingness to implement a ten year rate freeze (Petitioners Brief at 35). Due to the lack of record evidence needed to approve or deny such a request, the Department will not consider this proposal.

16. The Petitioners use the term DACC in place of Local Distribution Adjustment Clause ("LDAC"). The LDAC is a mechanism that allows an LDC to recover, or credit on a fully reconciling basis, costs that have been determined to be distribution-related costs but not included in base rates. Such costs include demand side management costs, environmental response costs associated with manufactured gas plants, and Federal Energy Regulatory Commission Order 636 transition costs. The LDAC is applicable to all firm customers (both sales and transportation). To maintain uniformity of terminology among the LDCs, the Department directs the Petitioners to use the term LDAC in the future.

17. As noted above, the Petitioners define exogenous factors as changes in tax laws, accounting principles, and regulatory, judicial, or legislative mandates (Exh. Cos.-A, at 19). The Petitioners do not indicate how such exogenous effects might be influenced by the structure envisioned by the Alternative Merger, if adopted. If Bay State were to become an operating division of a foreign corporation, Indiana-driven effects could not be visited upon Massachusetts ratepayers. See discussion at end of Section IV(I).

18. The Petitioners state that sometime before the end of Bay State's current rate plan on October 31, 1999, Bay State will submit proposed refinements to the quality of service standards and targets contained in that rate plan (Exh. Cos.-A at 18; Tr. 2, at 161).

19. The Petitioners calculate the \$31 million savings in incremental revenues during the five-year rate freeze by assuming \$1.8 million in cumulative base rate increases (\$27 million) plus \$800,000 per year in unbundling costs (\$4 million) (Petitioners Brief at 31).

20. G.L. c. 164, § 1E(b) sets forth certain requirements that pertain to performance-based regulation plans.

21. Bay State's recent rate case history is as follows: (1) Bay State Gas Company, D.P.U. 1122 (1982) (\$2.1 million increase); (2) Bay State Gas Company, D.P.U. 1535 (1985) (\$5.5 million increase); (3) Bay State Gas Company, D.P.U. 89-81 (1989) (\$12.4 million increase); (4) Bay State Gas Company, D.P.U. 92-111 (1992) (\$11.5 million increase); (5) Bay State Gas Company, D.T.E. 97-97 (1997) (\$3.6 million increase over two years).

22. The Petitioners' contention that the actual benefit of the rate freeze would be a savings of \$31 million for ratepayers is based on the assumption that Bay State would be entitled to -- and that the Department would approve -- \$1.8 million per year in cumulative base rate increases, as well as the annual recovery of \$800,000 in third-party unbundling costs. The current rate plan expires on October 31,

1999; and rate increases, allowed under the current plan, apply to the cost of service for that two-year settlement period and may not extend beyond that date. The Petitioners have not provided adequate support in the record for the validity of assuming that the conditions of the settlement would hold into the future. Therefore, the Department does not accept the Petitioners' savings estimate of \$31 million.

23. Performance Based Rate plans excepted.

24. Bay State Gas Company, D.P.U. 92-111, at 281-282 (1992).

25. The pushed down equity is the balance sheet effect associated with an acquisition premium under the purchase accounting method. Under purchase accounting, the acquisition premium would represent an intangible asset on the asset side of the balance sheet. The acquisition premium must also appear on the equity side of the balance sheet -- increasing the equity balance by the same amount of the acquisition premium as recorded on the asset side of the balance sheet. Including the acquisition premium in the common shareholders' equity balance substantially increases the denominator in the calculation of ROE. The net effect of including this amount in the common equity balance would significantly reduce the ROE (Exh. AG 3-1 (Bay State Gas Company, D.P.U. 93-167 Supp. Comments, Question 3, at 1)). The effect is expressed formulaically thus:

ROE = Net income - preferred shareholder dividends

Average common shareholders' equity

26. The Petitioners project that the annual benefits associated with bundled off-system sales, interruptible sales, and capacity release credits could result in an incremental increase of \$1.8 - 3.6 million per year as a result of joint management efforts depending on the regulatory environments under which the Petitioners operate

(Exh. AG-2-16 (Supp.) at 1).

27. The Customer-Choice Program is a pilot program by Bay State to identify and evaluate the mechanisms that affect a competitive gas supply market (Exh. Cos-1, at 10-11).

28. Northern Indiana purchases approximately 85 percent and Bay State purchases approximately 40 percent of their respective system supplies from the on-shore and off-shore Texas and Louisiana producing regions (Exh. AG 2-16 (Supp.) at 1). Moreover, both companies expect to purchase more Canadian supplies (id.). According to the Petitioners, joint purchasing of these supplies would lead to greater economies and efficiencies (id.).

29. Bay State and Northern Indiana have contracted capacity on Tennessee Gas Pipeline (Exh. AG 2-16 (Supp.)). Further, the two companies hold capacity on 16 interstate pipelines of which nine intersect and form industry-recognized trading hubs (id. at 1).

30. Weather normalization is an adjustment for weather based on a comparison of test year degree days to twenty-year average degree-day data obtained from an official weather data source. Fall River Gas Company, D.P.U. 750, at 8 (1981).

31. Decreasing net income would result in a smaller ROE. The opposite occurs during a year with warmer than normal temperatures.

32. The Settlement contains the following service quality measures and benchmarks: (1) customer survey responses indicating that Bay State met or exceeded customer expectations -- 94 percent in fiscal year ("FY") 1998, and 94.5 percent in FY 1999; (2) service appointments met on the day scheduled -- 94 percent in FY 1998, and 95 percent in FY 1999; (3) no more than 1.4 customer complaint cases per 1,000 customers, using the Department's Consumer Division statistics for both FY 1998 and FY 1999 (with a ten percent no-penalty bandwidth); (4) lost time incidents per 100 employees -- current three-year average not exceeding the previous year's three-year average; (5) response time to odor calls in one hour or less -- 95 percent for both FY 1998 and FY 1999; (6) current year of main and service damage incidents due to third parties -- not exceeding the previous year's three-year average; (7) emergency, and service and billing calls answered within 30 seconds -- 95 percent for both FY 1998 and FY 1999, and 80 percent for FY 1998 and FY 1999, respectively; and (8) actual on-cycle meter readings -- 88 percent in FY 1998 and 89 percent in FY 1999. Failure to comply with any one of these goals would carry a maximum penalty of \$250,000 per measure or a maximum penalty of \$2.0 million annually. For each measure, one-fourth of the maximum penalty would be assessed for each percentage point, or any portion thereof, that Bay State's performance falls short of the target. D.P.U. 97-97, at 4-5.

33. The Department directs companies filing requests for approval of mergers or acquisitions to include a service quality plan that is designed to prevent degradation of service following the merger. This directive reaffirms the importance of maintaining and improving service quality to customers. Eastern-Essex Acquisition at 33; Mergers and Acquisitions at 8-10.

34. The acquisition premium is a function of the purchase price of \$40 per share and the book value of the approximately 13,750,000 shares that the Petitioners estimate will be outstanding as of the consummation of the merger (Exh. AG 2-9). Subtracting the book value of approximately \$240 million from the total purchase price of \$550 million results in the \$310 million acquisition premium (id.).

35. The Petitioners state that the acquisition premium must be recorded on Bay State's consolidated books, in accordance with the guidelines set forth by the SEC in Staff Accounting Bulletin 54 (Exh. AG 2-14; Tr. 2, at 91-93).

36. As interpreted by the SEC, the Treasury Stock Condition requires that each of the combining enterprises reacquires shares of voting common stock only for purposes other than business combinations, and no enterprise reacquires more than a "normal" number of shares between the dates the plan of combination initiated and consummated (Exh. AG 2-13; Tr. 2, at 52-53, 55). Since 1989, NIPSCO Industries has had a stock repurchase program in effect, which has resulted in the repurchase of approximately 44 million shares of NIPSCO Industries common stock (Exh. Co.-B, Sch. MTM-2, at 46). A

significant number of these repurchased shares resulted from NIPSCO Industries' acquisition of IWC in 1997 (Exh. Co.-B, Sch. MTM-2, at 46).

37. APB 16 is a subsection of GAAP that specifies the rules to follow when entering into a business combination (Exh. AG 2-13). APB 16 states that a business combination may be recorded under pooling of interests accounting when it meets certain specified criteria, otherwise it must be recorded as a purchase (Exh. AG 2-13).

38. The SEC has defined the "normal" number of shares that can be repurchased under APB 16 as no greater than ten percent of the total number of shares to be issued under the business combination under review (Tr. 2, at 52-53, 55). The Petitioners estimated that, assuming 20 million NIPSCO Industries shares to be issued in conjunction with the merger, no more than two million shares could be held as repurchased shares and still meet the Treasury Stock condition (*id.* at 55). During 1997 alone, NIPSCO Industries repurchased approximately 25.2 million shares, most of which were associated with the IWC acquisition (Exhs. AG 1-3, at 43; Cos.-B, Sch. MTM-2, at 46).

39. -

40. The Attorney General's own witness agreed that the SAB 54 is dispositive of the need to reflect the acquisition premium on Bay State's books (Tr. 3, at 69).

41. The Attorney General's argument that Petitioners should be precluded from recording the merger using purchase accounting simply because Bay State commented favorably on the benefits of pooling of interests accounting in Mergers and Acquisitions is without merit. The Department construes Bay State's comments in that proceeding as a general indication of support of the use of pooling of interests accounting, not as proposing the use of pooling of interests accounting for all mergers and acquisitions.

42. Additionally, in Eastern-Essex Acquisition, the Department found that Eastern Enterprise's payment of 2.36 times the book value for Essex County Gas Company was reasonable. Eastern-Essex Acquisition at 65. It is, of course, possible that a future

§ 96 petition might seek recovery of an excessive premium, unwarranted by market evidence and offsetting benefits.

43. The Department expects that the Petitioners will begin to amortize the acquisition premium during the five-year term of the rate freeze and will not seek to recover any of the amortization of the acquisition premium from that five-year period at the end of the rate freeze. In other words, the Petitioners may not defer recovery of the entire acquisition premium to the 35 post-rate freeze years in which such recovery is allowed.

44. Consequently, the Department finds it premature to consider the Attorney General's proposal to assign all of the acquisition premium to Bay State's unregulated operations.

45. The Department took administrative notice of Bay State's Annual Returns to the Department for the years 1993 through 1997 pursuant to 220 C.M.R. § 1.10(3) (Tr. 3, at 38-39).

46. Long-term refers to periods of more than one year after the date of issuance.

G.L. c. 164, § 16.

47. The net plant test is derived from G.L. c. 164, § 16.

48. The Petitioners did not seek to include Northern Indiana as a participant in Bay State's funds pooling agreement (Petition at 6-7).

49. G.L. c. 164, § 8A(a) provides, in pertinent part, that a gas company shall not be authorized to engage in the business of an electric company and an electric company shall not be authorized to engage in the business of a gas company unless the Department, after notice and public hearing, certifies to the state secretary that the Department deems the public convenience will be promoted thereby.

50. Under the Alternative Merger, Northern Indiana would be the surviving company (Exhs. Co.-A at 28-29; Co.-B, Sch. MTM-4, at A-1).

51. An earlier version of G.L. c. 164, § 23, governed the acquisition of electric systems by gas companies, and the acquisition of gas systems by electric companies. The provisions of G.L. c. 164, § 23, were stricken and the subject matter replaced, in part, by G.L. c. 164, § 8A, pursuant to St. 1973, c. 860, §§ 8 and 13.

52. An Act Relative to Restructuring the Electric Utility Industry in the Commonwealth, Regulating the Provisions of Electricity and Other Services, and Promoting Enhanced Consumer Protection Therein. St. 1997, c. 164.

53. Section 189 of St. 1997, c. 164 changed the definition of "gas company" and "electric company" found in G.L. c. 164, § 1, so that a gas or electric company need not be a domestic Massachusetts corporation, provided such corporation is organized for the purpose of making and selling, or distributing and selling, gas and electricity within Massachusetts. Currently, Northern Indiana does not have any authority to operate within Massachusetts (Exh. AG 1-1, Sec. 4.3, at 3).

54. The Department notes that such a vote may not be necessary if the Preferred Merger is ultimately implemented (Tr. 2, at 83-84).

55. General Laws c. 156B, § 11, in relevant part, permits corporations to assume any name that has not been used by a corporation in current operation or had been in operation during the prior three years, unless written consent of the preexisting corporation is filed with the state secretary. The Department presumes that Bay State's

assent for Northern Indiana to operate in Massachusetts under the Bay State name would readily be obtained.

56. The Department recognizes the logic in this case for the Petitioners to offer "preferred" and "alternative" merger structures in order to meet the requirements imposed by other government agencies. However, presenting alternative proposals is not an efficient way of litigating a case and should be introduced only when absolutely necessary. The Department will require companies to demonstrate this necessity in the future.

57. Bay State's last fully adjudicated (i.e., not resolved by settlement) rate case was in 1992. Bay State Gas Company, D.P.U. 92-111 (1992). There currently is no obvious answer to the question of whether the cost of service findings in that case would suffice to establish Bay State's operating costs as an operating division of Northern Indiana.

58. For example, and by way of contrast to Massachusetts' situation, Northern Indiana's service territory of 12,000 square miles (Exh. Cos.-A, at Tab B, at 3) is nearly half again the size of the entire Commonwealth (8257 square miles, including all embayments and sounds, Merriam-Webster's New Geographical Dictionary at 738 (1984).